STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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July 25, 2003

Dear Interested Party :

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the August 6, 2003 Business Taxes Committee meeting. This meeting will address the proposed Regulation 1671.1, *Discounts, Coupons, Rebates and Other Incentives*.

Action 1 on the Agenda consists of items on which we believe industry and staff are in full agreement. Action 2 concerns the application of tax to buy-down rebate revenues. Action 3 concerns incorporating the application of tax to discounts and payments offered through grocery store discount club cards and other clarifying language. Action 4 concerns the operative date for the application of tax to buy-down rebate revenues.

If you wish to have any consent items (Action 1) discussed fully at the Committee meeting, you must contact a Board Member prior to July 31, 2003, to request removal of the item from the Consent Agenda. In addition, please notify Ms. Charlotte Paliani, Program Planning Manager, after you contact a Board Member's Office. Ms. Paliani may be reached at (916) 324-1825.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Board Meetings and Committee Information" page on the Board's Internet web site (http://www.boe.ca.gov/meetings/meetings.htm#two) for copies of Committee discussion or issue papers, minutes, a procedures manual and calendars arranged according to subject matter and by month.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **9:30 a.m.** on **August 6, 2003** in Room 121 at the address shown above.

Sincerely,

Ramon J. Hirsig
Deputy Director
Sales and Use Tax Department

RJH: lj

cc: (all with enclosures)
Honorable Carole Migden, Chairwoman
Honorable Claude Parrish, Vice Chairman
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable John Chiang, Member, Fourth District
Honorable Steve Westly, State Controller, C/O Ms. Marcy Jo Mandel
Ms. Carole Ruwart, Board Member's Office, First District (MIC 71)
Ms. Sabina Crocette, Board Member's Office, First District
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Mr. Romeo Vinzon, Board Member's Office, Third District (via e-mail)
Mr. Matthew Zylowski, Board Member's Office, Third District
Ms. Margaret Pennington, Board Member's Office, Second District (via e-mail)
Mr. Lee Williams, Board Member's Office, Second District (MIC 78 and via e-mail)
Mr. Tim Treichelt, Board Member's Office, Second District (via e-mail)
Mr. John Thiella, Board Member's Office, Fourth District (MIC 72)
Mr. Timothy Boyer (MIC 73)
Acting Chief Counsel (MIC 83)
Ms. Janice Thurston (MIC 82)
Mr. Warren Astleford (MIC 82)
Mr. Chris Schutz (MIC 82)
Ms. Jean Ogrod (via e-mail)
Mr. Jeff Vest (via e-mail)
Mr. David Levine (MIC 85)
Mr. Steve Ryan (via e-mail)
Mr. Rey Obligacion (via e-mail)
Ms. Jennifer Willis (MIC 70)
Mr. Dan Tokutomi (via e-mail)
Mr. Dave Hayes (MIC 67)
Ms. Charlotte Paliani (MIC 92)
Mr. Joseph Young (via e-mail)
Mr. Jerry Cornelius (via e-mail)
Mr. Jeffrey L. McGuire (via e-mail)
Mr. Vic Anderson (MIC 40 and via e-mail)
Mr. Larry Bergkamp (via e-mail)
Mr. Geoffrey E. Lyle (MIC 50)
Ms. Laureen Simpson (MIC 50)
Ms. Laura Jonoubei (MIC 50)
Ms. Leila Khabbaz (MIC 50)
Ms. Lania Glaude (AB)
Mr. Keith Leduff (AB)
Mr. Terry Mitchell (AC)
Ms. Cindy Feng (AP)
Mr. Gene Olague (AR)
Ms. Andnet Habtamariam (AS)
Mr. Alan Luu (CH)
Ms. Stephanie Brown (FH)

AGENDA — August 6, 2003 Business Taxes Committee Meeting

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

Action 1 — Agreed Upon Items Subdivisions (a) and (e)(3). Agenda, Page 3.	Adopt proposed language for Regulation 1671.1 (except as indicated in Actions 2, 3, and 4) as agreed upon by industry and staff**.**
Action 2 — Application of Tax to Buy-Down Rebate Revenues Subdivisions (d), and (e)(1). Agenda, Pages 5, 6, 7. Issue Paper Alternative 1.	Adopt either: 1) Staff's recommended language in subdivision (d), which provides that a retailer's rebate income is part of that retailer's gross receipts when (1) the buy-down rebate program involves a three-party transaction, and (2) the manufacturer or other third party requires a reduction in the retailer's product selling price; OR 2) Interested parties' proposed language for subdivision (d), which provides that in order for buy-down rebate revenue to be considered part of gross receipts two conditions must be met: (1) the manufacturer requires a reduction in the retailer's product selling price and (2) the customer has knowledge that the manufacturer will reimburse the retailer for the specified price reduction.
Action 3 — Incorporating the Application of Tax to Discounts and Payments Offered Through Grocery Store Discount Club Cards and Other Clarifying Language Subdivisions (b), (c), and (d). Agenda, Pages 4-5. Issue Paper Alternative 1.	Adopt either: 1) Staff's recommended language to incorporate the application of tax to discounts offered through grocery store club cards in subdivision (b) and other recommended clarifying language; OR 2) Interested parties proposed language to incorporate the application of tax to discounts offered through grocery store club cards in subdivision (b) and other proposed clarifying language.

AGENDA — August 6, 2003 Business Taxes Committee Meeting

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

Action 4 — Operative Date for Application of Tax to Buy-Down Rebate Revenues Subdivision (f). Agenda, Page 8. Issue Paper Alternative 1.	Adopt either: 1) Staff's recommendation of no operative date; OR 2) Interested parties' recommendation of an operative date for subdivision (d) as follows: (1) General Rule – The provisions of subdivision (d) shall apply to transactions that occur or petitions for redetermination filed but not yet final on or after the first day of the first quarter commencing after this regulation is approved by the Office of Administrative Law. (2) Application to Pending Controversies. (A) The provisions of subdivision (d) shall apply to petitions for redermination filed but not yet final as of operative date in (f)(1). (B) The provisions of subdivision (d) shall apply to claims for refund filed but not yet final as of January 1, 2003.
Action 5 — Authorization to Publish	Recommend the publication of the proposed Regulation 1671.1 as adopted in the above actions. Implementation: 30 days following OAL approval

AGENDA — August 6, 2003 Business Taxes Committee Meeting

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

Action Item	Staff and Industry's Proposed Regulatory Language
Action 1 — Agreed Upon Items	**Proposed Regulation 1671.1. DISCOUNTS, COUPONS, REBATES AND OTHER INCENTIVES.** *Reference:* Sections 6006-6012, Revenue and Taxation Code. Gifts Marketing Aids, Premiums and Prizes generally, see Regulation 1670 Trading Stamps and Related Promotional Plans generally, see Regulation 1671 **(a) IN GENERAL.** Manufacturers, vendors, and other third parties often engage in various programs that result in credits or payments made to retailers with respect to a retailer's taxable sale of tangible personal property to an end-use customer. These payments and credits include, but are not limited to, purchase and cash discounts, coupon reimbursements, ad or rack allowances, buy-downs, scanbacks, voluntary price reductions and other incentives, promotions, and rebates. Under certain conditions, payments received by the retailer in the form of rebates or other types of payments or credits for products sold at retail are included in the retailer's gross receipts or sales price from the sale of the product. **(e) EXAMPLES.** (3) The following are examples of situations involving payments by automobile manufacturers to automobile dealers or end-use customers with respect to the sale or lease of automobiles. **(A)** An automobile manufacturer provides a customer with a $1,000 rebate upon the purchase of a specific automobile. Rather than receive payment from the manufacturer, the customer assigns the rebate to the dealer who in turn applies the amount of that rebate toward the customer's payment for the vehicle. The $1,000 payment by the manufacturer is part of the dealer's gross receipts, since the rebate is provided to the customer who uses the rebate amount to partially satisfy that customer's total payment obligation to the dealer. The $1,000 rebate does not constitute a reduction in the retailer's gross receipts as a retailer's coupon, cash discount, purchase discount, or otherwise. **(B)** An automobile dealer receives a $500 incentive from the automobile manufacturer for every vehicle sold of a specific model in a given period. The manufacturer does not have an oral or written contract requiring the dealer to sell the specific model at a reduced price. The selling price is based solely on the dealer's discretion. Under these facts, the $500 payment by the manufacturer is not part of the dealer's gross receipts, since the manufacturer does not require a reduction in the retail selling price of the vehicle. The $500 incentive instead constitutes a reduction in the dealer's cost of goods sold

AGENDA — August 6, 2003 Business Taxes Committee Meeting

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)
Action 3- Incorporating the Application of Tax to Discounts and Payments Offered Through Grocery Store Discount Club Cards and Other Clarifying Language	(b) DISCOUNTS. (1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. **Generally, discounts provided to customers utilizing a grocery store discount club card are regarded as cash discounts or retailer coupons**. (2) PURCHASE DISCOUNTS are given by a vendor to that vendor's customer (i.e., a retailer) based upon the amount of prior purchases by that customer. The discounts are regarded as trade discounts and are **not additional** gross receipts. (3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are **not additional** gross receipts. **Generally, payments to a grocery store retailer pursuant to discounts offered through a grocery store discount club card are regarded as ad or rack allowances.** (c) COUPONS. (1) RETAILER COUPONS. A retailer may issue paper or paperless coupons which, when **utilized** by the purchaser, entitles the purchaser to buy tangible personal property at a certain amount or percentage off the advertised selling price. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the gross receipts from the sale. If, however, the customer has previously given	(b) DISCOUNTS. (1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. **Grocery store discount club cards are generally considered cash discounts.** (2) PURCHASE DISCOUNTS are given by a vendor to that vendor's customer (i.e., a retailer) based upon the amount of prior purchases by that customer. The discounts are regarded as trade discounts and are **excluded from** gross receipts. (3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are **excluded from** gross receipts**.** (c) COUPONS. (1) RETAILER COUPONS. A retailer may issue paper or paperless coupons which, when **presented to the retailer** by the purchaser, entitles the purchaser to buy tangible personal property at a certain amount or percentage off the advertised selling price. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the gross receipts from the sale. If, however, the

AGENDA — August 6, 2003 Business Taxes Committee Meeting

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)
Action 3- (con't) Incorporating the Application of Tax to Discounts and Payments Offered Through Grocery Store Discount Club Cards and Other Clarifying Language	compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts. (2) MANUFACTURER COUPONS. A manufacturer may fund paper or paperless coupons that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. Amounts paid by a manufacturer to a retailer for the redemption of a coupon used for the purchase of the manufacturer's products are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer. **Manufacturer's coupon programs may be known as "Coupon Redemptions," "Instant Rebates" or by a similar name**. (d) REBATES AND INCENTIVES. These are transactions involving buy-down programs, mark downs, discounts, coupons, rebates, and other price reductions. These rebate programs are also known as "Buy-Down Rebates," "Promotions," "Flex" (Flex Extensions), or by a similar name. Revenue received by the retailer from these types of programs or other similar types of programs is part of the retailer's gross receipts from the sale to a consumer when both of the following conditions are met: **(1) The buy-down rebate or similar program involves a three party transaction. A three party transaction exists when the retailer, the vendor to the retailer, and the manufacturer or some other third party not directly selling tangible personal property to the retailer, are each separate legal entities. A "separate legal entity" is defined as an entity that is a person under Section 6005, such as a corporation, limited partnership,**	customer has previously given compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts. (2) MANUFACTURER COUPONS. A manufacturer may fund paper or paperless coupons that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. Amounts paid by a manufacturer to a retailer for the redemption of a coupon used for the purchase of the manufacturer's products are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer. (d) REBATES AND INCENTIVES. These are transactions involving buy-down programs, mark downs, discounts, coupons, rebates, and other price reductions. These rebate programs are also known as "Buy-Down Rebates," **"Voluntary Price Reductions,"** "Promotions," "Flex" (Flex Extensions), **"Coupon Redemptions," "Scanbacks," "Instant Rebates"** or by a similar name. Revenue received by the retailer from these types of programs or other similar types of programs is part of the retailer's gross receipts from the sale to a consumer when both of the following conditions are met:
Action 2 – Application of Tax to Buy-Down Rebate Revenues		

AGENDA — August 6, 2003 Business Taxes Committee Meeting

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)
	general partnership, or limited liability company. A three party transaction exists even when one party wholly owns another party. In situations where the manufacturer is also the vendor to the retailer, as one legal entity, and no other third party provides a buy down or other similar type of payment to the retailer, the three party requirement is not met.	
Action 2 – Application of Tax to Buy-Down Rebate Revenues	**(2)** The manufacturer **or other third party** requires a reduction in the retailer's product selling price. A price reduction exists when the manufacturer **or other third party** requires, through a written or oral contract, the retailer to reduce the retailer's selling price of the product from the regular selling price. The price reduction can be a specific amount or a requirement to not exceed a specified reduced selling price. The fact that a retailer lowers **a product's** selling price and receives payment **from a manufacturer or other third party should not be considered as the only evidence that the manufacturer or other third party required a reduction in the retailer's product selling price**.	**(1)** The manufacturer requires a reduction in the retailer's product selling price. A price reduction exists when the manufacturer requires, through a written or oral contract, the retailer to reduce the retailer's selling price of the product from the regular selling price. The price reduction can be a specific amount or a requirement to not exceed a specified reduced selling price. The fact that a retailer lowers **his or her retail price** and receives payment **under a rebate program is not evidence that a contractual requirement exists to reduce the price as a condition for receiving payment**. **(2) The customer has knowledge that the manufacturer will reimburse the retailer for the specified price reduction. The customer knowledge can be in the form of a receipt, sticker, sign, display or other indicator that the retailer will receive a payment from the manufacturer for a specific amount in return for a reduction in the selling price of the product.**
	Both of the conditions above must be met in order for rebate income to be considered part of the retailer's gross receipts. If both of the conditions are not met, the rebate income will be considered a purchase discount and not includable in the retailer's gross receipts.	Both of the conditions above must be met in order for rebate income to be considered part of the retailer's gross receipts. If both of the conditions are not met, the rebate income will be considered a purchase discount and not includable in the retailer's gross receipts.
Action 2 – Application of Tax to Buy-Down Rebate Revenues	(e) EXAMPLES. (1) The following are examples of situations where payments received by the retailer from the manufacturer **or other third party** are part of the gross receipts from the sale of the product:	(e) EXAMPLES. (1) The following are examples of situations where payments received by the retailer from the manufacturer are part of the gross receipts from the sale of the product:

AGENDA — August 6, 2003 Business Taxes Committee Meeting

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)
Action 2 – Application of Tax to Buy-Down Rebate Revenues	**(A) Coupon on dog food bag says $2 off at register. Coupon indicates "Manufacturer's Coupon."** **(B) The retailer purchases dog food from its vendor, a separate legal entity from the manufacturer. The manufacturer requires that the retailer reduce the selling price of the product by $2. The manufacturer will reimburse the retailer $2 for each item sold at the end of the promotional period. The manufacturer may issue the retailer a rebate check directly or pay the distributor on behalf of the retailer.**	**(A) Coupon on dog food bag says $2 off at register. The coupon indicates "payable by Big Bad Dog Food Co. (BBDF Co.)" or "All promotional costs paid by BBDF Co."** **(B) Coupon on dog food bag says $2 off at register. Newspaper ad, notice at rack, or on receipt or elsewhere says "$2 coupon payable by BBDF Co."** **(C) The retailer purchases dog food from a distributor, a separate legal entity from the manufacturer (BBDF Co.). No coupon is present on the dog food bag. However, a newspaper ad or display notice states that a "price reduction is made possible by BBDF Co." and $2 is separately itemized on the retailer's receipt as the amount of price reduction.**
Action 2 – Application of Tax to Buy-Down Rebate Revenues	(2) The following are examples of situations where payments received by the retailer from the manufacturer **or other third party** are reductions to cost and not included in the retailer's gross receipts from the sale of the product: (A) Coupon on the dog food bag says $2 off at register. There is no indication on the coupon, in a newspaper ad, at the rack, on the receipt, or anywhere else that the retailer will receive $2 from another person to compensate for the $2 price reduction. The coupon is regarded as a retailer's coupon provided the coupon is not otherwise a rebate or incentive described in subdivision (d). **(B) The manufacturer sells dog food direct to the retailer and also issues a rebate check at the end of a promotional period for the sale of the dog food at a reduced selling price. As part of the rebate program, the manufacturer requires that the retailers**	(2) The following are examples of situations where payments received by the retailer from the manufacturer are reductions to cost and not included in the retailer's gross receipts from the sale of the product: (A) Coupon on the dog food bag says $2 off at register. There is no indication on the coupon, in a newspaper ad, at the rack, on the receipt, or anywhere else that the retailer will receive $2 from another person to compensate for the $2 price reduction. The coupon is regarded as a retailer's coupon provided the coupon is not otherwise a rebate or incentive described in subdivision (d). **(B) Sign at display says "price reduction made possible by BBDF Co." Bag is priced at $10, but there is no indication in a newspaper ad, at the rack, on the receipt, or anywhere else of the amount of the price reduction.**

AGENDA — August 6, 2003 Business Taxes Committee Meeting

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)
	selling price may not exceed a stated amount. Since this is a two party transaction, the rebate payment to the retailer is regarded as a reduction of the purchase price and not as gross receipts from the sale of the product. **(C) The manufacturer issues a rebate check to the retailer for $2 for each bag of dog food sold during a promotional period without regard to the selling price of the product. The rebate program was based on the number of bags sold and not on the number of bags sold at a reduced selling price. The retailer purchases the products through its vendor, a separate legal entity. Without a required reduction in the selling price of the dog food, the rebate income is regarded as a reduction in the purchase price and not as gross receipts.**	
Action 4- Operative Date for Application of Tax to Buy-Down Rebate Revenues		**(f) OPERATIVE DATE.** **(1) General Rule – The provisions of subdivision (d) shall apply to transactions that occur or petitions for redetermination filed but not yet final on or after the first day of the first quarter commencing after this regulation is approved by the Office of Administrative Law.** **(2) Application to Pending Controversies.** **A. The provisions of subdivision (d) shall apply to petitions for redermination filed but not yet final as of operative date in (f)(1).** **B. The provisions of subdivision (d) shall apply to claims for refund filed but not yet final as of January 1, 2003.**

Issue Paper Number **03 - 008**

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

- ☐ Board Meeting
- ☒ Business Taxes Committee
- ☐ Customer Services and Administrative Efficiency Committee
- ☐ Legislative Committee
- ☐ Property Tax Committee
- ☐ Other

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

I. Issue

Should proposed Regulation 1671.1, *Discounts, Coupons, Rebates and Other Incentives*, be published to clarify the application of tax to discounts, coupons, rebates and other incentives?

II. Staff Recommendation

Staff recommends adoption of its version of proposed Regulation 1671.1, *Discounts, Coupons, Rebates and other Incentives*, which is scheduled for discussion at the August 6, 2003 Business Taxes Committee meeting. See Exhibit 7 for staff's proposed text. Staff's proposed regulation reflects past findings of the Board, is intended to apply to all industries, and has no operative date. In particular, staff's version provides that a retailer's rebate income is part of that retailer's gross receipts when (1) the buy-down rebate program involves a three-party transaction and (2) the manufacturer or other third party requires a reduction in the retailer's product selling price. (See Issue Paper (IP) pages 5 through 12 and Agenda Item 2.)

III. Other Alternative(s) Considered

A. Alternative 1

As proposed by interested parties (see Alternative 1 page 12), adopt staff's recommended proposed language with the exception of the language in subdivision (b) that incorporates the application of tax to discounts offered through grocery store club cards and other clarifying language (see Agenda Item 3) and the application of tax to rebates and incentives in subdivisions (d) and (e). Interested parties propose that in order for buy-down rebate revenue to be considered part of gross receipts two conditions must be met: (1) the manufacturer requires a reduction in the retailer's product selling price and (2) the customer has knowledge that the manufacturer will reimburse the retailer for the specified price reduction. Interested parties' proposal does not require that the manufacturer is a third party to the transaction and furthermore does not address how tax applies to buy-down payments by persons who are not "manufacturers" of the underlying product sold. See Exhibit 8 for interested parties' proposed language. (See IP pages 12 through 16 and Agenda Item 2.)

Interested parties propose subdivision (f) containing two operative dates for subdivision (d) only (see Agenda Item 4):

(1) General Rule – The provisions of subdivision (d) shall apply to transactions that occur or petitions for redetermination filed but not yet final on or after the first day of the first quarter commencing after this regulation is approved by the Office of Administrative Law; and

(2) Application to Pending Controversies.

(a) The provisions of subdivision (d) shall apply to petitions for redetermination filed but not yet final as of operative date in (f)(1).

(b) The provisions of subdivision (d) shall apply to claims for refund filed but not yet final as of January 1, 2003.

IV. Background

Interested parties requested and were provided a legal analysis of staff's position on buy-down rebates by memorandum dated June 11, 2003. A copy of that memorandum is attached as Exhibit 3. Staff's position regarding the application of tax to buy-down rebates is summarized as follows:

Application of Tax to Gross Receipts

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt from taxation by statute. Sales tax is imposed on the retailer who may collect reimbursement from the customer if the contract of sale so provides. Where sales tax does not apply, such as when the sale takes place outside the state, use tax is imposed on the sales price of property purchased from a retailer for the storage, use, or other consumption of property inside this state. Gross receipts or sales price includes the total amount received with respect to the sale, with no deduction for the cost of materials, service, or expense of the retailer passed on to the purchaser, unless there is a specific statutory exclusion. Pursuant to Revenue and Taxation Code (RTC) sections 6011(b)(2) and 6012(b)(3), gross receipts and sales price also include any amount for which a credit is given to the purchaser by the seller. However, pursuant to RTC sections 6011(c)(1) and 6012(c)(1), gross receipts and sales price do not include cash discounts allowed and taken on sales.

Application of Tax to Third-Party Payments

The gross receipts from a retailer's retail sale may include amounts collected from someone other than the purchaser. For example, amounts received by a retailer for the redemption of a traditional manufacturer's coupon are part of the retailer's gross receipts. (See e.g., Annotation 295.0430, *Redemption of Coupons* (5/9/73).) In this type of situation, the retailer receives a portion of its gross receipts from the customer in the form of a reduced payment for tangible personal property, and another portion of its gross receipts from the manufacturer upon redemption of the manufacturer's coupon. (See also Annotation 550.0340, *Dinner Club Membership* (11/27/62).) Amounts received by a retailer from a third party may also be gross receipts whether or not the customer is aware of the third party's payment. For example, in *Anders v. State Board of Equalization* (1947) 82 Cal.App.2d 88, the court concluded that tips paid over to a restaurant by its waitresses were part of the restaurant's gross receipts, despite the fact that any tips received by the waitresses over and above the amount of their minimum wage belonged to them and despite the fact that tips ordinarily belong to the employee. Thus, the restaurant's receipt of payments from two separate sources (i.e., the restaurant's receipt of payments from customers as well as the restaurant's receipt of tips paid over to the restaurant by its waitresses) constituted gross receipts regardless of the customer's knowledge of the waitresses' payments in connection with the underlying sale. Moreover, amounts received by a retailer from a third party constitute gross receipts where the payment can be traced to particular sales of taxable property. In *Szabo Food Service v. State Board of Equalization* (1975) 46 Cal.App.3d 268, the court reaffirmed that "amounts received from more than one source may be included in gross receipts (see *Anders v. State Board of Equalization*, 82 Cal.App.2d 88 [185 P.2d 883]). . . ." (*Id*. at p. 273.) In addition, the court stated that in order for third party payments to be included in gross receipts, "[I]t is still necessary to establish that amounts received, from whatever source, are consideration for the sale, including services." (*Id.)*

Application of Tax to Two-Party and Three-Party Payments Involving Buy-Down Rebates

The Board considers gross receipts to include amounts a retailer receives from someone other than the retailer's vendor (hereafter "third party") when the third party requires the retailer to reduce its selling price of certain property as a condition of receiving the payment. When these conditions are met, the payment from the third party constitutes consideration for the retail sale and is a credit offered by the retailer to the customer for the underlying retail sale. This treatment is consistent with the *Anders* and *Szabo* cases discussed above. In this situation, the retailer receives payment for the property from two separate sources (i.e., the customer and the third party), both of which are part of the retailer's gross receipts. Conversely, when the transaction does not involve three parties, the Board has not historically considered rebate revenue received directly from a retailer's vendor (who may be the manufacturer in some cases) to be additional gross receipts from a retailer's retail sale. (See, e.g., Regulation 1602.5 (b)(1)(F)4, *Purchases for the Purchase-Ratio Method*; Annotation 295.0980, *Rebate Not a Cash Discount* (4/15/58); Annotation 295.1000, *Rebates* (11/20/64); Annotation 295.0880, *Billing and Collecting Charges* (1/31/58); and Annotation 295.0942, *Discounts Based on Prior Purchases* (12/3/93).) In this situation, the retailer and its direct vendor are free to negotiate the selling price of the property between them, which may consist of various types of cash discounts, volume rebates, quantity discounts or promotional allowances.

The Board's interpretation of the application of tax to revenues received by retailers from buy-down rebate programs stems from the results of two separate hearings before the Board and has been set forth in Board publications since 1998. The application of tax to sales of cigarettes that involve buy-down rebate programs was published in an article in the September 1998 Tax Information Bulletin (TIB) and in a section titled "Cigarette Rebates" in the January 1999 Tax Tips for Grocery Stores pamphlet (Publication 31). The Board's position regarding manufacturer buy-down rebate revenues was also published in the March 2003 TIB, which advised retailers to continue reporting tax on revenues received from buy-downs and similar rebate incentive programs. (The March 2003 TIB is available on the Board's Internet Website at: www.boe.ca.gov/news/pdf/mar03tib.pdf.)

History of Rebates Issue

Exhibit 4 contains a recent history of the rebates issue beginning with the meeting of the Business Taxes Committee (BTC) on October 31, 2000, and concluding with the placement of this topic on the BTC agenda for August 6, 2003. Exhibit 5 contains the status report on buy-down rebates dated November 26, 2001 and the related revenue estimate dated February 13, 2001 referenced in Exhibit 4.

Grocery Store Discount Club Cards

In October 1997, due to the advent of grocery store discount club cards and electronic coupons, the BTC was presented with an issue paper for discussion on the subject of grocery store discount cards and coupons. (See Exhibit 6.) The BTC found that discounts offered through grocery store discount club cards are similar to retailer's discount coupons and as such should be treated as non-taxable discounts. Any manufacturer payments received by the retailer were found to be reimbursements of advertising expenses and, therefore, were not subject to tax. The BTC further concluded, however, that tax would remain applicable to manufacturer coupons since the retailer receives the face value of such coupons in connection with its sale of tangible personal property. To the extent that grocery store discount club cards do not include retailer discounts or if payments received by the retailer are not for advertising expenses, staff believes that the application of tax to such rebates and/or payments is governed by proposed Regulation 1671.1 subdivisions (c)(2) and (d).

April 15, 2003 Interested Parties Meeting

An interested parties meeting was held on April 15, 2003, to discuss the proposed regulation. Several interested parties presented their concerns with staff's proposed version regarding the application of tax to rebates and incentives, especially the requirement that the transaction involve three parties. At the end of the meeting, several interested parties presented their support for an earlier industry version of the proposed regulation that required a third condition for rebates to be subject to tax: customer knowledge that the manufacturer will reimburse the retailer for the specified price reduction. Customer knowledge was a condition presented in industry's originally proposed version and not the version presented at the December 18, 2002 public hearing. This earlier industry version also differs from the language presented as interested parties' proposed regulation in the initial discussion paper distributed on March 28, 2003.

June 3, 2003 Interested Parties Meeting

A second interested parties meeting was held on June 3, 2003. Again, several interested parties presented their concerns with staff's proposed version regarding the application of tax to rebates and incentives, especially the requirement that the transaction involve three parties. An interested party requested a legal memorandum to explain the authority relied upon by staff in making a distinction between two-party and three-party payments. As noted earlier, on June 11, 2003, a legal opinion was prepared for Honorable Board Member Bill Leonard and a copy was distributed to all Board Members and interested parties. (See Exhibit 3.)

Interested Parties Submissions

Prior to June 3, 2003 interested parties meeting, staff received comments and submissions from the following interested parties:

Mr. John Roscoe, Mr. Keith Eastin, and Mr. Robert Mazur from Cigarettes Cheaper! (Cigarettes Cheaper!),

Mr. Greg Turner from the California Taxpayer's Association (Cal-Tax),

Mr. Paul Smith from the California Grocers Association (CGA),

Mr. Abe Golomb of Sales Tax Reduction Specialists (STRS),

Mr. Jim Ott of Enhanced Technologies Group (Enhanced Technologies),

Ms. Pat Leary of California State Association of Counties (CSAC),

Ms. Jean Flourney Korinke of League of California Cities (The League),

Ms. Barbara Hennessy from the City of Long Beach (Long Beach),

Mr. Dave Pope of Patton Music Co. Inc (Patton Music), and

Mr. Eric Miethke of Nielsen, Merksamer, Parrinello, Mueller & Naylor (Nielsen).

After the June 3, 2003 interested parties meeting, staff received submissions from Cigarettes Cheaper!, CGA, and Patton Music, which provided some comments and interested parties' version of proposed Regulation 1671.1. The CGA's proposed language was approved by Cigarettes Cheaper!, Cal-Tax, Nielsen, and Patton Music. Staff did not receive direct correspondence from Cal-Tax, Nielsen or other interested

parties. Therefore, the description of Alternative 1 is primarily based on interested parties' submissions received prior to the second interested parties meeting.

V. Staff Recommendation

A. Description of the Staff Recommendation

Staff recommends adoption of proposed Regulation 1671.1, *Discounts, Coupons, Rebates and other Incentives*, as shown in Exhibit 7. Staff's proposed regulation provides guidance and clarification regarding the application of tax to sales of tangible personal property that involve discounts, coupons, rebates, and other incentives. The specific areas of guidance include:

- Cash discounts – discounts offered by retailers to the retailer's customers for prompt payment
- Purchase discounts – discounts offered by vendors to retailers based on the volume of purchases
- Ad or rack allowances – allowances offered by manufacturers to retailers to advertise or display the manufacturer's product
- Retailer coupons – discount coupons offered by retailers to their customers
- Manufacturer coupons – coupons offered by manufacturers to retailers' customers
- Rebates and incentives – manufacturer or third party incentives to retailers to promote sales of the manufacturer's products

Staff's recommendation has no operative date.

CSAC, The League, and Long Beach all support staff's position and oppose any changes to current Board policy. They have stated that they do not support any amendments that would reduce revenues for the State.

A comparison between staff's and interested parties' proposed language can be found in Exhibit 2.

Application of Tax to Buy-Down Rebate Programs

Pursuant to the analysis set forth in Exhibit 3, staff regards a retailer's rebate income as part of that retailer's gross receipts when two conditions are met:

1. The buy-down rebate program involves a three-party transaction, and
2. The manufacturer or other third party requires a reduction in the retailer's product selling price.

If these conditions are not met, the manufacturer payments would be treated as a purchase discount and as such, considered as a reduction to cost of goods sold.

Staff's position is consistent with the recent New Mexico Court of Appeals decision of *Grogan, d/b/a Tobacco Patch, v. New Mexico Taxation and Revenue Department* (2002) 62 P.3d 1236, (Cert. Denied, New Mexico Supreme Court, January 31, 2003). New Mexico's Court of Appeals found that a retailer was subject to New Mexico's sales tax on receipts from "buy-down" contracts with cigarette manufacturers because the contracts did not result in excludable cash discounts allowed to the taxpayer's

customers. The "buy-down" contracts required the taxpayer to sell certain brands of cigarettes at a reduced price for a period of time specified by the manufacturers and also required the taxpayer to advertise the price reduction in accordance with the manufacturers' instructions. In return, the taxpayer was compensated by the manufacturers for the loss in sales revenue resulting from the reduced sales price.

The circumstances surrounding the "buy-down" contracts in the New Mexico case appear nearly identical to the "buy-down" contracts previously encountered by staff. In that regard, the New Mexico Court found that: (1) the "buy-down" payments placed the retailer in the same position as if the retailer had sold the cigarettes at non-discounted prices; (2) the "buy-down" payments were intended by the Legislature to constitute gross receipts; and (3) the retailer was not entitled to claim an exclusion from the gross receipts for cash discounts allowed and taken at the time of sale. In addition, the Court found that the imposition of the tax was on the retailer and that it was the retailer's decision as to how to compensate for that expense. A copy of the *Grogan* decision is attached as Exhibit 9.

Industries Affected by Staff's Proposed Regulation

Subdivision (d) of staff's proposed regulation regarding buy-down rebate programs would affect any industry engaging in programs that involve a three-party transaction where a third party (i.e., someone who did not sell the property to the retailer) requires the retailer to reduce a product's selling price as a condition of receiving the buy-down rebate amount. When these requirements are not met, the allowances paid under a promotional program would not be considered gross receipts, but rather a reduction of cost of goods sold. Staff understands that industries engaging in buy-down rebate programs may include persons other than tobacco retailers, despite the fact that most of the Board's awareness of buy-down rebate programs involve cigarettes.

Several interested parties have expressed concern that staff has a misconception of the industries affected by staff's proposed regulation. One interested party in particular, Enhanced Technologies, provided samples from two manufacturer's Internet websites of several competitive pricing programs in the computer industry. Based on a review of the sample programs, it appears that a few may require the retailer to verify that a selling price reduction was passed through to the customer. If this is the case, the manufacturer's rebate payments may be considered part of gross receipts. Enhanced Technologies agrees that the manufacturers' requirement that the retailers reduce their product selling price should remain in the proposed regulation if staff will not consider all rebates as reductions to cost of goods sold.

Two-Party Versus Three-Party Transactions

As noted earlier, staff makes a distinction between retailers who receive a rebate from the vendor directly selling to that retailer and retailers who receive a rebate from a person who did not directly sell to that retailer. The latter type of transaction is referred to as a three-party transaction. When a three-party transaction exists, the amounts received by the retailer from the manufacturer or other third party in exchange for reducing the selling price of the product are not reductions in the cost of goods sold, but instead constitute gross receipts or sales price received by the retailer from the sale. In situations where the retailer purchases directly from the manufacturer, a two-party transaction exists and the rebate revenues received from the manufacturer are not part of gross receipts.

Cal-Tax, Cigarettes Cheaper!, and CGA believe that taxing third-party payments arbitrarily discriminates against small retailers because they are less likely to purchase directly from manufacturers. In addition, Cal-Tax believes that there is no authority for staff's position that a reduction in cost of

goods sold can only be accomplished by a payment from the retailer's vendor and not the manufacturer when three parties are involved.

Staff believes that all aspects of business operations create advantages and disadvantages for all retailers as well as consumers. Staff is not discouraging retailers from purchasing through distributors, but rather is making a distinction between purchase discounts provided by vendors and additional gross receipts provided by third-party manufacturer rebate programs. The sales and use tax laws and regulations do not dictate the purchasing practices of retailers or consumers.

Staff's Response to Interested Parties' Requirement of Customer Knowledge

Staff believes that the imposition of tax on a sale that involves a rebate payment does not depend on whether or not the customer has knowledge of the rebate payment. As noted previously, the reported California court decisions of *Anders* and *Szabo* do not require customer knowledge of a third-party's payment in order for the payment to be part of gross receipts. It is only necessary that the third-party payment be consideration for the underlying sale. There has been no reported decision that has placed a requirement of customer knowledge since the imposition of the sales tax is on the retailer and not the end-use customer. (The customer only pays tax reimbursement to the retailer if the contract so provides.) Moreover, making customer knowledge a requirement for imposing tax creates a nearly impossible audit burden. It is virtually impossible for an auditor to establish what a customer might have known at the time of a sale, especially when an audit often occurs three or more years after the sale itself took place. As such, placing a premium on customer knowledge for tax purposes effectively permits every buy-down rebate transaction to escape taxation.

Both Cal-Tax and Cigarettes Cheaper! believe that the amount on which a retailer should be required to pay tax is only that amount paid to the retailer by a customer. Cal-Tax believes that RTC section 6011(a) provides that the sales price is the "agreed to" price between the buyer and seller and not some other price of which the purchaser is unaware. Therefore, rebate payments are outside the "agreed to" price and not part of gross receipts. Staff disagrees based on the analysis set forth in Exhibit 3. In particular, there is simply no language within RTC sections 6011(a) and 6012(a) that limits gross receipts or sales price to "the agreed to price between the buyer and seller" as suggested by industry.

Cal-Tax references deleted Annotation 295.0940, *Cooperative Dividends* (8/10/59), as support for its position that the "agreed to" price between the customer and the retailer is the shelf price. This annotation stated:

> Where a cooperative sells only to its members and is required to sell at cost, even though the items are billed out at a price in excess of cost, the true "sales price" (and hence the correct "gross receipts") is the agreed price, i.e., cost and the refund of the excess is merely an adjustment to the agreed price.

Staff does not agree that this is an argument in support of excluding tax from third-party buy-downs. This annotation, which was deleted in 2001 due to lack of legal analysis, appears to be similar to a retailer's coupon and would be considered a cash discount. There appears to be no other reimbursement received by the cooperative.

Cal-Tax further references the court case *Pacific Coast Engineering Company v. State of California* (1952) 111 Cal. App. 2d 31 as additional support that rebate payments are not part of the "sales price" and outside the "agreed to" price between the buyer and the seller. Cal-Tax cites the following sentence from that case for its position:

> The buyer-consumer has no obligation in reference to the tax. As to him the "selling price" is the amount he must pay to obtain the goods whether or not the sales tax forms a part of the selling price.

Staff does not believe that this case support's Cal-Tax's position. The *Pacific Coast Engineering* case involves whether a buyer is liable to the seller for tax reimbursement even though no such provision for the buyer to reimburse the seller for the sales tax was made in the contract of sale. This is not a case that states that rebate payments are not part of the sales price. Staff further notes that the "selling price" of property to the end-use customer may or may not consist of the entire gross receipts a retailer receives with respect to a sale.

Staff's Comments to Other Theories Introduced by Interested Parties

Both Cal-Tax and CGA believe that there are two transactions involved in a rebate situation: one transaction between the manufacturer and the retailer, and one transaction between the retailer and the customer. According to Cal-Tax, the consideration being paid by the manufacturer to the retailer is not for the sale of tangible personal property, but rather for a previously executed agreement to reduce the selling price of a product for a specified period of time and should be excluded from gross receipts. Cal-Tax believes that the consideration paid by the customer is the "agreed to" price that should be considered gross receipts.

Staff relies on the court decisions of *Anders* and *Szabo* providing that payments by a third party pursuant to a separate contract are part of a retailer's gross receipts where the payments are consideration for the sale. Buy-downs requiring the retailer to reduce its selling price of certain property are part of the sale since the retailer would not otherwise sell the property at the reduced price. Thus, when a retailer reduces its selling price as a requirement in order to receive payments from a third party, the total amount received from both the customer and the third party is subject to tax.

Cal-Tax also believes that third-party buy-downs are not subject to tax since Annotation 490.0440, *Credits* (3/14/69), provides that payments from a manufacturer to a retailer as part of an agreement under which the retailer agreed to lower its sales price to an identified group of customers were excluded from gross receipts. Cal-Tax asserts that in this annotation staff noted that payments from the manufacturer were not considered gross receipts because a bilateral contract between the manufacturer and the retailer pre-dated the sale. In reviewing the back-up documentation to this annotation, however, it appears to staff that the transaction involved only two parties, such that the credits could have been considered a reduction to cost of goods sold.

Nielsen further provided a trial court transcript from the Illinois Circuit Court case of *Ogden Chrysler Plymouth, Inc. v. Glen Bower* (Jan. 17, 2003.) Nielsen provided the following brief summary of the court's conclusion:

> Although this was a "2-party" transaction in the Board's framework of analysis, the Court did not focus on this in deciding in the taxpayer's favor. In rejecting the "gross receipts" argument advanced by the state, the judge focused on the concept of "consideration" and "selling price" and determined that the consumer never bargained for the payment of the rebate payment, and therefore it was not part of the consideration for the sale. This is consistent with yesterday's discussion that the 3-party transaction is really two separate transactions – one for the shelf price for the sale of tangible personal property, and a separate contract between the

> manufacturer and the retailer for something other than the sale of tangible personal property.

Staff notes, however, that this case involves a two-party transaction that is presently not subject to tax and that this is a decision of a trial court and is not a reported decision of a Court of Appeal. Staff further notes that California does not only look to the amount paid by a customer for purposes of determining a retailer's gross receipts. Instead, staff believes that where a third party requires a retailer to reduce its selling price of specific property in order to receive a buy-down payment, that buy-down payment directly relates to and is part of the underlying sale such that the buy-down is part of the retailer's gross receipts. In that regard, staff believes that the Illinois case of *Ogden* is not consistent with the California cases of *Anders* and *Szabo* and is therefore inapplicable.

CGA also believes that the proposed regulation would create the need for a two-tiered pricing structure, one for the product sales and one structure for sales tax purposes. CGA claims that point-of-sale (POS) systems currently used by retailers are not designed to handle two-tiered pricing structures. CGA states that the POS systems in place are only designed to accept the sale of individual products by assigning an offer price that is accepted by a customer who then consummates the sale contract with either cash, check, credit card, debit card, or manufacturer's coupon, all of which are presented at the time of finalizing the sale (sales contract). Moreover, CGA states that this two-tiered pricing structure could increase the probability that a retailer would violate Business and Professions Code (BPC) section 12024.2. The first paragraph of BPC section 12024.2(a) states:

> It is unlawful for any person to compute, at the time of sale of a commodity, a value which is not a true extension of a price per unit which is then advertised, posted, or quoted or to change, at the time of sale of a commodity, a value which is more than the price which is then advertised, posted or quoted.

Staff notes, however, that POS systems are constantly being modified in order to account for new and different marketing strategies employed by retailers, as well as various accounting changes and changes in the law. Staff further notes that current POS systems presently handle sales of cellular devices in which the taxable measure of a cellular phone may greatly exceed the selling price to the customer. (See Regulation 1585, *Cellular Phones, Pagers, and Other Wireless Telecommunication Devices.*)

Staff interprets BPC section 12024.2 to require that a consumer be charged the price that is advertised or stated for the commodity being purchased. This section does not, however, govern the amount upon which sales tax is calculated. In that regard, there are currently many instances where industry calculates sales tax on an amount that is different than the selling price advertised and charged to the customer. For example, with manufacturer coupons the price charged the customer is different than the amount upon which the measure of tax is calculated. Another example, as noted above, is in the cellular telephone industry with respect to sales of cellular phones in bundled transactions. In a bundled transaction, a cellular device may be sold at a discounted price, but the retailer is still required to report and pay tax measured by the unbundled price. In most cases, the retailer collects tax reimbursement on the unbundled sales price, which is an amount that is usually much higher than the actual amount the customer is charged for the cellular device. To date, staff is unaware of any BPC violations based on the collection of tax reimbursement measured by amounts in excess of the selling price of tangible personal property to an end-use customer.

Emerging Issue Task Force Numbers 00-14, 00-25, and 02-16

The Emerging Issue Task Force (EITF) was formed on the recommendation of the Financial Accounting Standards Board (FASB) for purposes of reaching a consensus on emerging financial accounting issues. Recently, the EITF addressed accounting for certain sales incentives in several issues, specifically:

- No. 00-14, Accounting for Certain Sales Incentives (applies to manufacturers' accounting methods),
- No. 00-25, Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor's Products (applies to manufacturers' accounting methods), and
- No. 02-16, Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor (addresses in part, a retailer's accounting methods for cash consideration).

Cigarettes Cheaper! asserts that EITF Nos. 00-14, 00-25, and 02-16 require that manufacturers and retailers account for sales incentives provided to retailers as a reduction of cost of goods sold for financial accounting purposes. Staff notes, however, that the EITF and FASB do not reach conclusions regarding sales and use tax issues. On that basis, staff believes that the finding of the EITF (and/or FASB) are not controlling with respect to the application of tax to buy-down payments for California sales and use tax purposes. Moreover, EITF Nos. 00-14 and 00-25 address the reporting requirements for manufactures and not retailers. Since sales tax is imposed on the retailer (and not on the retailer's vendor like that of a manufacturer), how a manufacturer accounts for a buy-down payment is irrelevant for sales and use tax purposes. To the extent EITF 02-16 addresses a retailer's financial accounting treatment of a buy-down, it does not do so with respect to a third-party buy-down. Thus, EITF No. 02-16 is consistent with staff's position with respect to two-party transactions and is silent as to those transactions the Board has previously found to be subject to tax.

Purported Reversal of Board Policy

Cal-Tax and Cigarettes Cheaper! believe that the Board has historically considered manufacturer buy-down rebates as adjustments to cost of goods sold and that any change in tax application should be on a prospective basis. According to Cigarettes Cheaper!, retailers are not consistently applying tax to buy-down rebate revenues.

The Board's guidance to the public has consistently stated that manufacturer buy-down rebates are part of gross receipts. See for example, "Cigarette Buy-Down Rebates Paid by Manufacturers or Other Third Parties Are Taxable" in the September 1998 Tax Information Bulletin and "Cigarette Rebates" on page 5 of Publication 31, Tax Tips for Grocery Stores (January 1999). All publications have indicated that buy-down rebate income is taxable when there is a three-party transaction and when the manufacturer requires the retailer to reduce the selling price of the product. Staff regrets if any internal documents may have led to a different conclusion. Any taxpayer receiving erroneous advice in writing may rely upon that advice as set forth in RTC section 6596 if the Board finds that a person's failure to make a timely return or payment is due to the person's reasonable reliance on written advice from the Board.

Cigarettes Cheaper! states that "the vast majority of retailers in California are not charging tax on tobacco products that are subject to a known rebate," and asserts that the state does not routinely audit small stores. Routine audits of taxpayers holding seller's permits are included in the Board's audit program to encourage compliance with the tax laws. Taxpayers selected for audit include businesses of all sizes. With respect to buy-down rebates, until the retailers' purchasing practices are determined,

Board staff cannot speculate as to whether rebate revenues received by the retailer are subject to tax. In audits involving buy-down rebate income, the buy-down rebate income has been consistently treated by staff as taxable gross receipts.

Grocery Store Discount Club Cards

Consistent with the Board's findings in Formal Issue Paper 10-97*, Grocery Store Discount Cards and Coupons*, staff recommends incorporating in subdivision (b) the Board's interpretation that retailer's discounts offered through grocery store discount club cards are generally regarded as cash discounts or retailers' coupons provided the retailer is offering the discount without reimbursement from the manufacturer. In addition, any payments received from the manufacturer should be excluded from gross receipts provided such payments are for the reimbursement of advertising expenses. Manufacturer payments for reimbursement of coupons or specified buy-down rebate programs would still be subject to tax. Retailers would be required to correctly account for cash discounts and manufacturer coupons or buy-down rebate programs.

Staff's Comments Regarding Interested Parties' Proposed Operative Date Language

Interested parties propose an operative date for subdivision (d) that shall apply to transactions that occur or petitions for redetermination filed but not yet final on or after the first day of the first quarter commencing after the Office of Administrative Law (OAL) approves the regulation. In addition, interested parties propose an operative date for claims for refund filed but not yet final of January 1, 2003. Staff believes that the proposed operative date in industry's language would treat taxpayers differently for the same time period.

B. Pros of the Staff Recommendation

- Promulgates current Board policy regarding the taxability of discounts, coupons, rebates and other incentives.
- Is consistent with interpretations of Section 6011 and 6012 found in cases and annotations involving the application of tax to rebates and incentives.

C. Cons of the Staff Recommendation

Requires adoption of a new regulation.

D. Statutory or Regulatory Change

No statutory change is required. However, staff's recommendation does require the adoption of a new regulation.

E. Administrative Impact

Staff will be required to notify taxpayers of the new regulation through an article in the Tax Information Bulletin (TIB) and distribute the adopted regulation.

F. Fiscal Impact

1. Cost Impact

There will be no additional costs. Staff will notify taxpayers of the new regulation through a Tax Information Bulletin (TIB) article. The workload associated with the publication and distribution of the TIB is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

None. The proposed regulation clarifies existing statute and policy. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Will enhance taxpayer/customer understanding of the application of tax to discounts, coupons, rebates and other incentives.

H. Critical Time Frames

The proposed regulation represents an interpretation of existing statutes and, therefore, has no operative date. Implementation will take place 30 days following approval of the regulation by the State Office of Administrative Law.

VI. Alternative 1

A. Description of the Alternative

As proposed by interested parties (California Grocers Association (CGA), Cigarettes Cheaper!, California Taxpayers Association (Cal-Tax), Sales Tax Reduction Specialists (STRS), Patton Music, and Nielsen, Merksamer, Parrinello, Mueller & Naylor (Nielsen)), adopt staff's recommended proposed language with the exception of the language in subdivision (b) that incorporates the application of tax to discounts offered through grocery store club cards, other clarifying language, the application of tax to rebates and incentives in subdivision (d), and an operative date in subdivision (f). The interested parties propose that in order for buy-down rebate revenue to be considered part of gross receipts the following two conditions have to be met: (1) the manufacturer requires a reduction in the product selling price and (2) the customer has knowledge that the manufacturer will reimburse the retailer for the specified price reduction. Interested parties' proposal does not make the distinction between two and three party transactions and furthermore does not address how tax applies to buy-down payments by persons who are not "manufacturers" of the underlying product sold.

Interested parties propose in subdivision (f) containing two operative dates for subdivision (d) only:

(1) General Rule – The provisions of subdivision (d) shall apply to transactions that occur or petitions for redeterrmination filed but not yet final on or after the first day of the first quarter commencing after this regulation is approved by the Office of Administrative Law; and

(2) Application to Pending Controversies.

(a) The provisions of subdivision (d) shall apply to petitions for redetermination filed but not yet final as of operative date in (f)(1).

(b) The provisions of subdivision (d) shall apply to claims for refund filed but not yet final as of January 1, 2003.

A comparison between staff's and interested parties' proposed language can be found in Exhibit 2.

Removal of Third-Party Requirement

Interested parties have removed the requirement that the manufacturer must be a third party to a transaction that involves a buy-down rebate program in order for the rebate amount to be subject to tax. Interested parties believe that by removing this requirement small retailers will not be penalized over those entities that are large enough to buy direct from the manufacturer. That is, the nature of the rebate payment is the same and should be treated as such. Cal-Tax, Cigarettes Cheaper!, and CGA believe that taxing third-party payments arbitrarily discriminates against small retailers because they are less likely to purchase directly from manufacturers. In addition, Cal-Tax believes that there is no authority for staff's position that a reduction in cost of goods sold can only be accomplished by a payment from the retailer's vendor and not the manufacturer when three parties are involved.

Cigarettes Cheaper! supports its position by citing several issues from the Financial Accounting Standards Board's recent Emerging Issues Task Force (EITF), specifically EITF Issue No. 00-14, *Accounting for Certain Sales Incentives*, No. 00-25, *Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor's Products,* and 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*.

Since FASB came to the conclusion in EITF No. 00-14 and No. 00-25 that manufacturers should not include payments to resellers for promotional allowance programs as part of gross receipts, Cigarettes Cheaper! believes that the reseller should also be able to consider the payments received as reductions to cost of goods sold. Cigarettes Cheaper! believes that FASB does not distinguish between manufacturers that are involved in two-party or three-party transactions, and therefore, the Board should not either.

In addition, Cigarettes Cheaper! cites the following from EITF No. 02-16:

> At the November 21, 2002 meeting, the task force reached a consensus on Issue 1 that cash consideration received by a customer from a vendor is presumed to be a reduction of the prices of the vendor's products or services and should, therefore, be characterized as a reduction of cost of sales when recognized in the customer's income statement.

As such, Cigarettes Cheaper! concludes that buy-down rebates are reductions to cost of goods sold, regardless if the rebate payment is received from a manufacturer or other distributor.

Customer Knowledge Requirement

Interested parties believe that the inclusion of customer knowledge should be a requirement for rebate revenues to be considered part of gross receipts since customer knowledge is fundamental to any application of sales taxes regarding the sales of products where a rebate program is involved. Interested parties also believe that RTC section 6011 implicitly assumes the existence of a sales contract in the definition of "sales price," and Section 6012 does the same by its inference to the "amount of the sale" in the definition of "gross receipts." Both Cal-Tax and Cigarettes Cheaper! believe that the amount a

retailer should be required to pay tax on is only that amount paid to the retailer by a customer. Cal-Tax believes that the RTC section 6011(a) provides that the sales price is the "agreed to" price between the buyer and seller and not some other price of which the purchaser is unaware. Therefore, rebate payments are outside the "agreed to" price and not part of gross receipts.

Cal-Tax references deleted Annotation 295.0940, *Cooperative Dividends* (8/10/59), as support for its position that the "agreed to" price between the customer and the retailer is the shelf price. This annotation stated:

> Where a cooperative sells only to its members and is required to sell at cost, even though the items are billed out at a price in excess of cost, the true "sales price" (and hence the correct "gross receipts") is the agreed price, i.e., cost and the refund of the excess is merely an adjustment to the agreed price.

In addition, Cal-Tax references the court case *Pacific Coast Engineering Company v. State of California* 111 Cal. App. 2d 31 (1952) as additional support that rebate payments are not part of the "sales price" and outside the "agreed to" price between the buyer and the seller. Cal-Tax cites the following sentence from that case for its position:

> The buyer-consumer has no obligation in reference to the tax. As to him the "*selling price*" is the amount he must pay to obtain the goods whether or not the sales tax forms a part of the selling price. (Emphasis added.).

Both Cal-Tax and CGA believe that there are two transactions involved in a rebate situation: one transaction between the manufacturer and the retailer, and one transaction between the retailer and the customer. According to Cal-Tax, the consideration being paid by the manufacturer to the retailer is not for the sale of tangible personal property, but rather for a previously executed agreement to reduce the selling price of a product for a specified period of time and should be excluded from gross receipts. Cal-Tax believes that the consideration paid by the customer is the "agreed to" price that should be considered gross receipts.

In addition, interested parties point out that Business and Professions Code section 12024.2 makes it unlawful for any person to compute, at the time of the sale of a commodity, a value which is not the true extension of a price per unit which is then advertised, posted , or quoted or to charge, at the time of sale of the commodity, a value which is more than the price which is then advertised, posted or quoted. CGA believes that the proposed regulation would create the need for a two-tiered pricing structure, one for the product sales and one for sales tax purposes. CGA claims that point-of-sale (POS) systems currently used by retailers are not designed to handle two-tiered pricing structures. CGA states that the POS systems in place are only designed to accept the sale of individual products by assigning an offer price that is accepted by a customer who then consummates the sale contract with either cash, check, credit card, debit card, or manufacturer's coupon, all of which are presented at the time of finalizing the sale (sales contract). Moreover, CGA states that this two-tiered pricing structure could increase the probability that a retailer would violate Business and Professions Code (BPC) section 12024.2.

Cal-Tax believes that third-party buy-downs are not subject to tax since Annotation 490.0440, *Credits* (3/14/69), provides that payments from a manufacturer to a retailer as part of an agreement under which the retailer agreed to lower its sales price to an identified group of customers were excluded from gross receipts. Cal-Tax believes that in this annotation staff noted that payments from the manufacturer were not considered gross receipts because a bilateral contract between the manufacturer and the retailer pre-dated the sale.

Nielsen further provided a trial court transcript from the Illinois Circuit Court case of *Ogden Chrysler Plymouth, Inc. v. Glen Bower* (Jan. 17, 2003.) Nielsen provided the following brief summary of the court's conclusion:

> Although this was a "2-party" transaction in the Board's framework of analysis, the Court did not focus on this in deciding in the taxpayer's favor. In rejecting the "gross receipts" argument advanced by the state, the judge focused on the concept of "consideration" and "selling price" and determined that the consumer never bargained for the payment of the rebate payment, and therefore it was not part of the consideration for the sale. This is consistent with yesterday's discussion that the 3-party transaction is really two separate transactions – one for the shelf price for the sale of tangible personal property and a separate contract between the manufacturer and the retailer for something other than the sale of tangible personal property.

B. Pros of the Alternative

- Provides the same application of tax to buy-down rebate revenues received from the manufacturer, whether the taxpayer buys direct from the manufacturer or through a separate vendor.
- Does not charge tax on an amount higher than what the customer agrees to pay for the sale of the product.
- Incorporates industry's proposal.

C. Cons of the Alternative

- Creates a new requirement of customer knowledge when determining if revenues received by retailers are part of gross receipts.
- Does not address how tax applies to "buy-down" payments by persons who are not "manufacturers" of the underlying product sold, but who are third parties making payments to retailers and who require the selling price of a product to be reduced.
- Requires adoption of a new regulation.

D. Statutory or Regulatory Change

No statutory change is required. The adoption of a new regulation is required.

E. Administrative Impact

Staff will be required to notify taxpayers of the new interpretation of RTC section 6011 and 6012 as it relates to the application of tax to rebate revenues through an article in the Tax Information Bulletin (TIB) and distribute the adopted proposed regulation.

F. Fiscal Impact

1. Cost Impact

There will be no additional costs. Staff will notify taxpayers of the new regulation through a Tax Information Bulletin (TIB) article. The workload associated with the publication and distribution of the TIB is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

The impact on revenue is expected to be a loss of $35,800,000 annually and a one-time loss of $2,900,000. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Will enhance taxpayer/customer understanding of the application of tax to discounts, coupons, rebates and other incentives.

H. Critical Time Frames

The proposed regulation represents an interpretation of existing statutes and, therefore, has no operative date with the exception of subdivision (d), rebates and other incentives. Subdivision (f) provides that the provision of subdivision (d) shall apply to transactions that occur or petitions for redetermination filed but not yet final on or after the first day of the first quarter commencing after the OAL approves the regulation. In addition, the operative date for claims for refund filed but not yet final is January 1, 2003.

Prepared by: Program Planning Division, Sales and Use Tax Department

Current as of: July 21, 2003

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

BOARD OF EQUALIZATION
REVENUE ESTIMATE

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives

Recommendations and Alternatives

Staff Recommendation

Staff recommends adoption of its version of proposed Regulation 1671.1, *Discounts, Coupons, Rebates and other Incentives*, which is scheduled for discussion at the August 6, 2003 Business Taxes Committee meeting. Staff's proposed regulation reflects past findings of the Board, is intended to apply to all industries, and has no operative date. In particular, staff's version provides that a retailer's rebate income is part of that retailer's gross receipts when (1) the buy-down rebate program involves a three-party transaction, and (2) the manufacturer or other third party requires a reduction in the retailer's product selling price.

Alternative 1

As proposed by interested parties, adopt staff's recommended proposed language with the exception of the language in subdivision (b) that incorporates the application of tax to discounts offered through grocery store club cards, other clarifying language and the application of tax to rebates and incentives in subdivisions (d) and (e). Interested parties propose that in order for buy-down rebate revenue to be considered part of gross receipts two conditions must be met: (1) the manufacturer requires a reduction in the retailer's product selling price and (2) the customer has knowledge that the manufacturer will reimburse the retailer for the specified price reduction. Interested parties' proposal does not require that the manufacturer is a third party to the transaction and furthermore does not address how tax applies to buy-down payments by persons who are not "manufacturers" of the underlying product sold.

Interested parties propose subdivision (f) containing two operative dates for subdivision (d) only:

(1) General Rule – The provisions of subdivision (d) shall apply to transactions that occur or petitions for redetermination filed but not yet final on or after the first day of the first quarter commencing after this regulation is approved by the Office of Administrative Law; and

(2) Application to Pending Controversies.
(a) The provisions of subdivision (d) shall apply to petitions for redetermination filed but not yet final as of operative date in (f)(1).
(b) The provisions of subdivision (d) shall apply to claims for refund filed but not yet final as of January 1, 2003.

Background, Methodology, and Assumptions

Staff Recommendation:

There is nothing in the staff's proposed Regulation 1671.1 that would impact revenues. The proposed regulation reflects past findings and interpretations of the Board regarding the application of tax to discounts, coupons, rebates, and other incentives.

Alternative 1:

Introduction:

The following industries were analyzed to determine the revenue impact for Alternative 1. These estimates are based on the assumption that the customer has no knowledge that a buy-down program (reduction in sales price) exists between the retailer and manufacturer or a third party.

Cigarette and Tobacco Products

The Sales and Use Tax Department (SUTD) contacted tobacco manufacturers requesting information on their buy-down rebate programs. Information provided by tobacco manufacturers that command 45% of the cigarette market shows that they issued $66 million in rebate disbursements to California retailers during calendar year 2000.

If we assume that the other tobacco manufacturers had similar rebate programs, then the total disbursements of rebates to California retailers would amount to $146.7 million. ($66 million / 45% = $146.7 million.) The sales and use tax on this amount would be $11.6 million ($146.7 x 7.92%). The $146.7 million represents 3% of the estimated taxable sales of cigarettes.

Drug Stores, Grocers, and Mass Merchandiser Rebates

The California Grocers Association (CGA) also provided us with a general product list of items on which rebates might be offered. They also provided information from two of their members indicating that they received rebates on detergents, paper products, carbonated soft drinks and alcoholic beverages in addition to rebates on tobacco products. While some information has been supplied by the CGA, staff has been unable to verify this information.

To estimate the amount of rebates on products other than cigarettes, we first calculated the annual taxable sales for retailers most likely to use buy-down rebates as promotional incentives. We assumed that drug stores, grocers, and mass merchandise stores were more likely to use rebate promotions through the many manufacturers and the numerous product lines engaged in business with these types of retailers. Taxable sales for the three industry groups noted above amounted to just over $30.5 billion in calendar year 2001. If we assume that 1% of their taxable sales are from buy-down rebate promotions, as opposed to the 3% of taxable sales attributable

to the buy-down rebate program on cigarette and tobacco products, as noted above, then taxable sales on these buy-down rebates amount to $305.4 million annually, as shown below:

Industry Group	Taxable Sales (in millions)
Grocers	$124.5
Mass Merchandisers	125.6
Drug Stores	55.3
Total	$305.4

The revenue impact on state and local sales tax amounted to $24.2 million ($305.4 million x 7.92%).

Conclusion:

Alternative 1 will impact a total $452.1 million in taxable sales ($146.7 million from Cigarette and Tobacco Products + 305.4 million as noted above).

Revenue Summary

Staff Recommendation:

The staff recommendation has no revenue impact.

Alternative 1:

On-Going Revenue Impact
The impact from the Alternative 1 proposed Regulation 1671.1 would result in a revenue loss to state and local sales tax in the amount of $35.8 million, ($452.1 million x 7.92%) as shown below:

	State and Local Revenue
State Loss (5.00%)	$ 22.6 Million
Local Loss (2.25%)	$ 10.2 Million
Special District Loss (0.67%)	$ 3.0 Million
Total State and Local Revenue Loss	$ 35.8 Million

One-Time Revenue Impact
In addition to the on-going annual revenue loss enumerated above, Alternative 1 would also require the provisions to apply to petitions for redetermination filed but not yet final on or after the first day of the first quarter commencing after this regulation is approved by the Office of Administrative Law, and to claims for refund filed but not yet final as of January 1, 2003. There are a number of such claims, primarily on cigarette rebates, that amount to $2.9 million in tax. This would be a one-time revenue loss.

Qualifying Remarks

Buy-down rebate programs are not limited to the industry groups we note above. We are aware that the computer and electronics industries do offer similar types of rebate programs to their retailers. However, not all of these programs require a price reduction to the sale price of the subject products. We have not been able to quantify the value of these buy-down programs.

Consequently, this estimate does not include the value of tangible personal property that may be impacted by Alternative 1 from these industries.

Preparation

Bill Benson, Jr., Research and Statistics Section, Administration Department prepared this revenue estimate. Mr. Dave Hayes, Manager, Research and Statistics Section, Legislative Division and Ms. Charlotte Paliani, Program Planning Manager, Sales and Use Tax Department reviewed this revenue estimate. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of July 23, 2003.

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives
Comparison of Proposed Language
Current as of July 21, 2003

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)	Summary Comments
Action 3- Incorporating the Application of Tax to Discounts and Payments Offered Through Grocery Store Discount Club Cards and Other Clarifying Language	Regulation 1671.1. DISCOUNTS, COUPONS, REBATES AND OTHER INCENTIVES. (b) DISCOUNTS. (1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. **Generally, discounts provided to customers utilizing a grocery store discount club card are regarded as cash discounts or retailer coupons.** (2) PURCHASE DISCOUNTS are given by a vendor to that vendor's customer (i.e., a retailer) based upon the amount of prior purchases by that customer. The discounts are regarded as trade discounts and are **not additional** gross receipts. (3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are **not additional** gross receipts. **Generally, payments to a grocery store retailer pursuant to discounts offered through a grocery store discount club card are regarded as ad or rack allowances.**	Regulation 1671.1. DISCOUNTS, COUPONS, REBATES AND OTHER INCENTIVES. (b) DISCOUNTS. (1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. **Grocery store discount club cards are generally considered cash discounts.** (2) PURCHASE DISCOUNTS are given by a vendor to that vendor's customer (i.e., a retailer) based upon the amount of prior purchases by that customer. The discounts are regarded as trade discounts and are **excluded from** gross receipts. (3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are **excluded from** gross receipts.	Staff recommends incorporating the application of tax to the discounts and payments offered through grocery store discount club cards in subdivisions (b)(1) and (b)(3) consistent with the Board's previous findings in Formal Issue Paper 10-97, *Grocery Store Discount Cards and Coupons*. The Board previously concluded that discounts allowed to customers pursuant to discount card programs were similar to retailer's discount coupons and that corresponding payments to a grocery store retailer were for reimbursement of advertising expenses. The Board also concluded that tax remains applicable to amounts received from manufacturers' coupons since the retailer receives the face value of such coupons in connection with the sale of tangible personal property. Staff believes the word "generally" should be used to describe: (1) the application of tax to discounts provided by grocery store discount club cards since the actual application of tax to such discounts depends on

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives
Comparison of Proposed Language
Current as of July 21, 2003

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)	Summary Comments
			whether the discount provided to the customer is pursuant to a retailer's or manufacturer's coupon; and (2) the application of tax to payments made to a grocery store retailer since the taxability of such payments depends on whether the payment is for advertising expenses pursuant to a manufacturer's coupon or other taxable type of payment. Interested parties prefer the terminology used in the original customer knowledge version authorized for publication on April 18, 2002.
Action 3- Incorporating the Application of Tax to Discounts and Payments Offered Through Grocery Store Discount Club Cards and Other Clarifying Language	(c) COUPONS. (1) RETAILER COUPONS. A retailer may issue paper or paperless coupons which, when **utilized** by the purchaser, entitles the purchaser to buy tangible personal property at a certain amount or percentage off the advertised selling price. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the gross receipts from the sale. If, however, the customer has previously given compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts.	(c) COUPONS. (1) RETAILER COUPONS. A retailer may issue paper or paperless coupons which, when **presented to the retailer** by the purchaser, entitles the purchaser to buy tangible personal property at a certain amount or percentage off the advertised selling price. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the gross receipts from the sale. If, however, the customer has previously given compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts.	Staff recommends the term "utilized" since paperless coupons cannot be presented by the purchaser to the retailer to receive the discount. Interested parties prefer the terminology used in the original customer knowledge version authorized for publication on April 18, 2002.

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives
Comparison of Proposed Language
Current as of July 21, 2003

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)	Summary Comments
Action 3- Incorporating the Application of Tax to Discounts and Payments Offered Through Grocery Store	(2) MANUFACTURER COUPONS. A manufacturer may fund paper or paperless coupons that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. Amounts paid by a manufacturer to a retailer for the redemption of a coupon used for the purchase of the manufacturer's products are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer. **Manufacturer's coupon programs may be known as "Coupon Redemptions," "Instant Rebates" or by a similar name**.	(2) MANUFACTURER COUPONS. A manufacturer may fund paper or paperless coupons that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. Amounts paid by a manufacturer to a retailer for the redemption of a coupon used for the purchase of the manufacturer's products are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer.	Staff believes that the examples listed in subdivision (c)(2) involve manufacturer coupons and are not examples of rebates and incentives.
Discount Club Cards and Other Clarifying Language	(d) REBATES AND INCENTIVES. These are transactions involving buy-down programs, mark downs, discounts, coupons, rebates, and other price reductions. These rebate programs are also known as "Buy-Down Rebates," "Promotions," "Flex" (Flex Extensions), or by a similar name. Revenue received by the retailer from these types of programs or other similar types of programs is part of the retailer's gross receipts from the sale to a consumer when both of the following conditions are met:	(d) REBATES AND INCENTIVES. These are transactions involving buy-down programs, mark downs, discounts, coupons, rebates, and other price reductions. These rebate programs are also known as "Buy-Down Rebates," **"Voluntary Price Reductions,"** "Promotions," "Flex" (Flex Extensions), **"Coupon Redemptions," "Scanbacks," "Instant Rebates"** or by a similar name. Revenue received by the retailer from these types of programs or other similar types of programs is part of the retailer's gross receipts from the sale to a consumer when both of the following conditions are met:	
Action 2 – Application of Tax to Buy-Down Rebate Revenues	**(1) The buy-down rebate or similar program involves a three party transaction. A three party transaction exists when the retailer, the vendor to the retailer, and the manufacturer or some other third party not directly selling tangible personal property to the retailer, are each separate legal entities. A "separate legal entity" is defined as an entity that is a person under Section 6005, such as a corporation, limited partnership, general partnership, or limited liability company. A three party transaction exists**		Staff believes that buy-down rebate revenues are part of gross receipts when (1) the buy-down rebate program involves a three-party transaction, and (2) the manufacturer or other third party requires a reduction in the retailer's product selling price.

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives
Comparison of Proposed Language
Current as of July 21, 2003

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)	Summary Comments
	even when one party wholly owns another party. In situations where the manufacturer is also the vendor to the retailer, as one legal entity, and no other third party provides a buy down or other similar type of payment to the retailer, the three party requirement is not met.		
Action 2 – Application of Tax to Buy-Down Rebate Revenues	**(2)** The manufacturer **or other third party** requires a reduction in the retailer's product selling price. A price reduction exists when the manufacturer **or other third party** requires, through a written or oral contract, the retailer to reduce the retailer's selling price of the product from the regular selling price. The price reduction can be a specific amount or a requirement to not exceed a specified reduced selling price. The fact that a retailer lowers **a product's** selling price and receives payment **from a manufacturer or other third party should not be considered as the only evidence that the manufacturer or other third party required a reduction in the retailer's product selling price**.	**(1)** The manufacturer requires a reduction in the retailer's product selling price. A price reduction exists when the manufacturer requires, through a written or oral contract, the retailer to reduce the retailer's selling price of the product from the regular selling price. The price reduction can be a specific amount or a requirement to not exceed a specified reduced selling price. The fact that a retailer lowers **his or her retail price** and receives payment **under a rebate program is not evidence that a contractual requirement exists to reduce the price as a condition for receiving payment**.	Staff believes that buy-down payments from a "third party" who is not the manufacturer of the underlying product sold is also part of a retailer's gross receipts.
Action 2 – Application of Tax to Buy-Down Rebate Revenues		**(2) The customer has knowledge that the manufacturer will reimburse the retailer for the specified price reduction. The customer knowledge can be in the form of a receipt, sticker, sign, display or other indicator that the retailer will receive a payment from the manufacturer for a specific amount in return for a reduction in the selling price of the product.**	Interested parties believe that buy-down rebate revenues are part of gross receipts only when (1) the manufacturer requires a reduction in the retailer's product selling price and (2) the customer has knowledge that the manufacturer will reimburse the retailer for the specified price reduction.
	Both of the conditions above must be met in order for rebate income to be considered part of the retailer's gross receipts. If both of the conditions are not met, the rebate income will be considered a purchase discount and not includable in the retailer's gross receipts.	Both of the conditions above must be met in order for rebate income to be considered part of the retailer's gross receipts. If both of the conditions are not met, the rebate income will be considered a purchase discount and not includable in the retailer's gross receipts.	

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives
Comparison of Proposed Language
Current as of July 21, 2003

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)	Summary Comments
Action 2 – Application of Tax to Buy-Down Rebate Revenues	(e) EXAMPLES. (1) The following are examples of situations where payments received by the retailer from the manufacturer **or other third party** are part of the gross receipts from the sale of the product:	(e) EXAMPLES. (1) The following are examples of situations where payments received by the retailer from the manufacturer are part of the gross receipts from the sale of the product:	See staff's comment on page 4 regarding subdivision (d)(2).
Action 2 – Application of Tax to Buy-Down Rebate Revenues	**(A) Coupon on dog food bag says $2 off at register. Coupon indicates "Manufacturer's Coupon."** **(B) The retailer purchases dog food from its vendor, a separate legal entity from the manufacturer. The manufacturer requires that the retailer reduce the selling price of the product by $2. The manufacturer will reimburse the retailer $2 for each item sold at the end of the promotional period. The manufacturer may issue the retailer a rebate check directly or pay the distributor on behalf of the retailer.**	**(A) Coupon on dog food bag says $2 off at register. The coupon indicates "payable by Big Bad Dog Food Co. (BBDF Co.)" or "All promotional costs paid by BBDF Co."** **(B) Coupon on dog food bag says $2 off at register. Newspaper ad, notice at rack, or on receipt or elsewhere says "$2 coupon payable by BBDF Co."** **(C) The retailer purchases dog food from a distributor, a separate legal entity from the manufacturer (BBDF Co.). No coupon is present on the dog food bag. However, a newspaper ad or display notice states that a "price reduction is made possible by BBDF Co." and $2 is separately itemized on the retailer's receipt as the amount of price reduction.**	Staff and interested parties propose different examples to demonstrate the application of tax proposed.
Action 2 – Application of Tax to Buy-Down Rebate Revenues	(2) The following are examples of situations where payments received by the retailer from the manufacturer **or other third party** are reductions to cost and not included in the retailer's gross receipts from the sale of the product: (A) Coupon on the dog food bag says $2 off at register. There is no indication on the coupon, in a newspaper ad, at the rack, on the receipt, or anywhere else that the retailer will receive $2 from another person to	(2) The following are examples of situations where payments received by the retailer from the manufacturer are reductions to cost and not included in the retailer's gross receipts from the sale of the product: (A) Coupon on the dog food bag says $2 off at register. There is no indication on the coupon, in a newspaper ad, at the rack, on the receipt, or anywhere else that the retailer will receive $2 from another person to compensate for the $2 price reduction. The coupon is	See staff's comment on page 4 regarding subdivision (d)(2).

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives
Comparison of Proposed Language
Current as of July 21, 2003

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)	Summary Comments
	compensate for the $2 price reduction. The coupon is regarded as a retailer's coupon provided the coupon is not otherwise a rebate or incentive described in subdivision (d).	regarded as a retailer's coupon provided the coupon is not otherwise a rebate or incentive described in subdivision (d).	
	(B) The manufacturer sells dog food direct to the retailer and also issues a rebate check at the end of a promotional period for the sale of the dog food at a reduced selling price. As part of the rebate program, the manufacturer requires that the retailers selling price may not exceed a stated amount. Since this is a two party transaction, the rebate payment to the retailer is regarded as a reduction of the purchase price and not as gross receipts from the sale of the product.	**(B) Sign at display says "price reduction made possible by BBDF Co." Bag is priced at $10, but there is no indication in a newspaper ad, at the rack, on the receipt, or anywhere else of the amount of the price reduction.**	Staff and interested parties propose different examples to demonstrate the application of tax proposed.
	(C) The manufacturer issues a rebate check to the retailer for $2 for each bag of dog food sold during a promotional period without regard to the selling price of the product. The rebate program was based on the number of bags sold and not on the number of bags sold at a reduced selling price. The retailer purchases the products through its vendor, a separate legal entity. Without a required reduction in the selling price of the dog food, the rebate income is regarded as a reduction in the purchase price and not as gross receipts.		
Action 4- Operative Date for Application of Tax to Buy-Down Rebate Revenues		**(f) OPERATIVE DATE.** **(1) General Rule – The provisions of subdivision (d) shall apply to transactions that occur or petitions for redetermination filed but not yet final on or after the first day of the first quarter commencing after this regulation is approved by the Office of Administrative Law.**	Interested parties recommend an operative date for subdivision (d) as noted. Staff believes that the proposed operative date would treat taxpayers differently for the same time period.

Proposed Regulation 1671.1, Discounts, Coupons, Rebates and Other Incentives
Comparison of Proposed Language
Current as of July 21, 2003

Action Item	Language Proposed by Staff	Language Proposed by Industry (Alternative 1)	Summary Comments
		(2) Application to Pending Controversies. **A. The provisions of subdivision (d) shall apply to petitions for redetermination filed but not yet final as of operative date in (f)(1).** **B. The provisions of subdivision (d) shall apply to claims for refund filed but not yet final as of January 1, 2003.**	

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State of California

Board of Equalization
Office of the Chief Counsel - MIC:83

M e m o r a n d u m

To : Honorable Bill Leonard
Member, Second District

Date: June 11, 2003

From : Jean Ogrod
Acting Chief Counsel

Telephone: (916) 324-2614
CalNet 454-2614

Subject: Proposed Regulation 1671.1
Request for Legal Analysis

Attached is staff's response to Tax Consultant Expert Margaret Pennington's June 4, 2003 e-mail to Assistant Chief Counsel Janice Thurston requesting an analysis of staff's position on buy-down rebates as set forth in staff's version of proposed Regulation 1671.1. If you have any questions on this matter or would like additional information please contact Ms. Thurston at (916) 324-2588 or Mr. Astleford at (916) 324-2637.

JO/bb
Attachment

cc: Honorable Carole Migden, Chairwoman
Honorable Claude Parrish, Vice Chairman
Honorable John Chiang
Honorable Steve Westly
Mr. Timothy Boyer (MIC: 83)
Mr. Ramon Hirsig (MIC: 43)
Ms. Charlotte Paliani (MIC: 92)
Mr. Geoffrey Lyle (MIC: 50)
Ms. Laureen Simpson (MIC: 50)
Ms. Laura Jonoubei (MIC:50)
Ms. Leila Khabbaz (MIC: 50)
Ms. Janice Thurston (MIC: 82)
Mr. Warren Astleford (MIC: 82)
Mr. Chris Schutz (MIC: 82)
(All w/attachments)

State of California
Equalization

Board of

Office of the Chief Counsel - MIC:83

M e m o r a n d u m

To : Ms. Jean Ogrod
Acting Chief Counsel

Date: June 11, 2003

From : Janice Thurston
Assistant Chief Counsel

Telephone: (916) 324-2588
CalNet 454-2588

Subject: Proposed Regulation 1671.1
Request for Legal Analysis

This is in response to Tax Consultant Expert Margaret Pennington's June 4, 2003 e-mail to me requesting an analysis of staff's position on buy-down rebates as specified in staff's version of proposed Regulation 1671.1.

Ms. Pennington's e-mail requested clarification of:

> "The logic and law for drawing a taxable distinction between payments made in the form of a rebate or buy-down from a direct supplier of a product to a retailer and the same or similar payment on the same product coming from the manufacturer of that product to the retailer bypassing the distributor. Why in the hands of a small retailer supplied by a distributor is the payment taxable, but when paid to a retailer supplied directly by the manufacturer it is a reduction in the cost of goods sold? Is there an economic distinction?
>
> "Is there something specific in the statutory or regulatory law that requires this distinction? It's not just any third-party payment. It's THE manufacturer of THE product that is the subject to a specific sale which is providing the rebate." (Emphasis in original.)

The history of proposed Regulation 1671.1 is set forth in Exhibit 3 to the Second Discussion Paper (copy attached). Based on staff's version of the proposed regulation, payments made to a retailer by any third party not directly selling property to that retailer are part of the retailer's gross receipts provided the third party requires a reduction in the selling price of the property. (A copy of staff's version of proposed Regulation 1671.1 is attached as Exhibit 1 to the Second Discussion Paper.) In order to respond to your inquiry, we have provided a brief analysis of the significant issues surrounding buy-down rebates and the rationale for imposing tax on these types of payments.

1. Underlying Basis for Tax Liability.

As a starting point, California imposes a sales tax on the retailer measured by the retailer's gross receipts from the retail sale of tangible personal property in this state, unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code, § 6051.) Although this tax is imposed on the retailer, the retailer may collect reimbursement from its customer if the contract of sale so provides. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § (hereafter "Reg." or "Regulation") 1700.) Where sales tax does not apply, such as when the sale takes place outside the state, use tax is imposed on the sales price of property purchased from a retailer for the storage, use, or other consumption of property inside this state. (Rev. & Tax. Code, §§ 6201, 6401.) This tax is imposed on the person actually storing, using, or otherwise consuming the property. (Rev. & Tax. Code, § 6202.) A retailer engaged in business inside this state is required to collect this tax from its customers and remit it to this Board. (Rev. & Tax. Code, §§ 6202, 6203.)

2. Gross Receipts May Include Amounts from Third Parties.

Taxable gross receipts or sales price include all amounts received with respect to the sale, with no deduction for the cost of materials, service, or expense of the retailer passed on to the purchaser, unless there is a specific statutory exclusion. (Rev. & Tax. Code, §§ 6011, 6012.) Gross receipts and sales price specifically include all receipts, cash, property of any kind, and any amount for which credit is allowed by the seller to the purchaser. (*Id*.) Gross receipts and sales price are not solely limited to amounts collected from an end-use customer, but instead may be generated from additional sources. For example, amounts received by a retailer for the redemption of a traditional manufacturer's coupon are part of the retailer's gross receipts. (See BTLG Annot. 295.0430 (5/9/73).) In this type of situation, the retailer receives a portion of its gross receipts from the customer in the form of a reduced payment for tangible personal property, and another portion of its gross receipts from the manufacturer upon redemption of the manufacturer's coupon. The retailer credits the amount it will ultimately receive from the manufacturer to the customer as part of the underlying retail sale.

Amounts received by a retailer from a third party may be gross receipts whether or not the customer is aware of the third party's payment. In *Anders v. State Board of Equalization* (1947) 82 Cal.App.2d 88, a restaurant operator was assessed tax on a portion of the tips received by waitresses who served the restaurant's taxable food products to customers. By agreement between the restaurant and the waitresses, tips received by the waitresses became the property of

the restaurant to the extent necessary to pay the waitresses' minimum wages as required by the Industrial Welfare Commission. The specific issue addressed by the court was "whether tips received by waitresses in a restaurant on account of their services, to the extent of their minimum wages fixed by law, become part of the gross receipts of the employer for sales of tangible personal property . . . in view of the contract of employment to the effect that such tips shall be credited to the payment of minimum wages as a part of the waitresses' compensation for services. . . ." (*Id*. at pp. 91-92.) The court concluded that the tips were in fact part of the restaurant's gross receipts (*id*. at p. 92), despite the fact that any tips received by the waitresses over and above the amount of their minimum wage belonged to them (*id*. p. 93), and despite the fact that tips ordinarily belong to the employee (*id.* at p. 94). Thus, the restaurant's receipt of payments from two separate sources (i.e., the restaurant's receipt of payments from customers as well as the restaurant's receipt of tips paid over to the restaurant by its waitresses) constituted gross receipts with respect to the restaurant's sale of taxable food products.

Amounts received by a retailer from a third party constitute gross receipts where the payment can be traced to particular sales of taxable property. In *Szabo Food Service v. State Board of Equalization* (1975) 46 Cal.App.3d 268, employees purchased meals directly from vendors located at the employer's premises at employer-approved prices. The employer thereafter made periodic supplemental or "subsidy" payments to the food vendor in order to guarantee the vendor a "reasonable profit and g[ive] it an incentive to continue to provide cafeteria service to employees at reasonable prices." (*Id*. at p. 272.) The court held that the subsidy payments were not subject to sales tax since: 1) "The employees who purchased the cafeteria meals provided the only consideration for the meals;" and 2) "The subsidy cannot be traced to particular sales of particular meals." (*Ibid*.) Despite the Board's loss in this case, the court reaffirmed that "amounts received from more than one source may be included in gross receipts (see *Anders v. State Board of Equalization*, 82 Cal.App.2d 88 [185 P.2d 883]). . . ." (*Id*. at p. 273.) Moreover, the court added that in order for third party payments to be included in gross receipts, "[I]t is still necessary to establish that amounts received, from whatever source, are consideration for the sale, including services." (*Id.)*

The principles set forth in *Anders* and *Szabo* are easily illustrated in the "half-off" bar example on pages six and seven of the Second Discussion Paper. In this hypothetical, one patron offers to pay one-half of all other patron's drinks for a one-hour period. The bar owner therefore receives payments from both the customer purchasing a drink at half price, as well as amounts from the patron agreeing to pay half of all other customer purchases. The bar owner's receipts from its sale of a drink come from two separate sources (one-half from the customer consuming the drink and one-half from the patron agreeing to pay half), both of which relate to the sale of that drink. The payment from the patron agreeing to pay half is part of the bar owner's gross receipts since it can easily be traced to particular sales of drinks by the bar owner and is consideration for the sale since the bar owner would not otherwise have sold the drink at half price. If the one-half payment was not subject to tax, the gross receipts from virtually any sale of tangible personal property could be artificially reduced through the use of third parties who could reduce the true selling price of property by providing a partial "non-taxable" payment to a retailer.

3. Third Party Buy-Downs Are Consideration For The Retail Sale.

The taxable buy-down contracts encountered by staff to date involve a payment to a retailer from someone other than the retailer's vendor (hereafter "third party"). The third party provides the payment to the retailer on the condition that the retailer reduces its selling price of specific tangible personal property. The buy-down amounts are not subsidy payments designed to guarantee a reasonable profit or to maintain "reasonable prices" like the subsidy payments in *Szabo*. Moreover, the taxable buy-down contracts encountered to date can be traced to particular sales of particular products. With respect to cigarette buy-downs, third parties tie the buy-down amount to the sale of very specific types or brands of cigarettes in order for the retailer to receive the buy-down. Pursuant to *Szabo* and *Anders*, these third party payments directly relate to and can be traced to the retailer's sale of specific property and are therefore included in the retailer's gross receipts.

Third party buy-downs requiring a price reduction are also part of gross receipts pursuant to Revenue and Taxation Code section 6011(b)(2) and 6012(b)(3). Subdivisions (b)(2) and (b)(3) include in gross receipts and sales price any amount for which a credit is given to the purchaser by the seller. Consistent with *Szabo*, when a retailer receives payment from a third party on the condition that the retailer reduce the selling price of specific property, the payment from the third party creates a credit that the retailer provides to its customer at the time of the retail sale.

4. Two-Party Price Adjustments Are Not Part of Gross Receipts.

While gross receipts and sales price ordinarily include all amounts received with respect to a sale, staff has historically regarded rebates, payments, and other types of discounts between a retailer and its direct vendor as a reduction in the cost of goods sold and not part of gross receipts. For example, Regulation 1602.5 provides reporting methods for grocers selling both exempt food products as well as taxable non-grocery products. Subdivision (b)(1) provides that "grocers may claim as sales of exempt food products that proportion of their total gross receipts from the sale of 'grocery items' that the amount of their purchases of exempt food products bears to their total purchases of grocery items." Subdivision (b)(1)(F)4. further provides that "'Purchases' means the actual amount which a grocer is required to pay to the **suppliers of merchandise**, net of any cash discounts, volume rebates or quantity discounts and promotional allowances." (Emphasis added.) In other words, to determine that portion of a grocer's gross receipts, the proportion of the grocer's exempt food purchases to total grocery items purchased is applied to the grocer's total sales. Regulation 1602.5 requires the grocer to calculate that proportion after the application of any cash discounts, volume rebates, quantity discounts, or promotional allowances provided to the grocer by its supplier. That same requirement does not exist, however, with respect to buy-downs, rebates, or other payments by a third party to the grocer. Consistent with the provisions of Regulation 1602.5, staff believes that cash discounts, volume rebates, quantity discounts and promotional allowances are not part of gross receipts when they are provided to a retailer by that retailer's supplier and not by an independent third party.

The Board's Annotations further demonstrate that a reduction to gross receipts requires that the price adjustment be made between the person selling the property and the purchaser. Annotation 295.0980 (4/15/58) provides that "A retailer may not exclude from gross receipts an amount paid to a school as a rebate on purchases made by its students. A cash discount is excludible from gross receipts only when given to the purchaser." (See also BTLG Annot. 295.1000 (11/20/64).) Annotation 295.0880 (1/31/58) provides that "The customer is the party who must receive the benefit of the discount in order for the retailer to exclude it from his gross receipts. Compensation paid by a restaurant to certain organizations for their services in billing and collecting from their members is not a cash discount." Annotation 295.0942 (12/3/93) also provides that "A taxpayer gives price discounts to customers based upon the amount of prior purchases. The discounts are regarded as trade discounts and are not included in the amount subject to tax."

With respect to Ms. Pennington's specific question, staff's view is that the imposition of tax on a two party or on a three party rebate payment to a retailer differs based on whether the person providing the rebate is also the person that directly sold the property subject to the rebate to the retailer. Where the person providing the rebate did not directly sell the underlying property to the retailer (i.e., the transaction involves a third party payment), the payment received by the retailer is part of the retailer's gross receipts or sales price provided the payment can be traced to particular sales of particular property. In this situation, the retailer merely receives payment for the property from two separate sources (i.e., the customer and the third party), both of which are part of the retailer's gross receipts. Further, staff's view is that the third party payment can be traced to particular sales where the third party requires the retailer to reduce the selling price of certain property in order for the retailer to receive the buy-down payment. When these conditions are met, the application of tax to the third party's payment is consistent with the findings of *Anders* and *Szabo* and is part of the retailer's gross receipts. Conversely, where the person providing the rebate did directly sell the underlying property to the retailer (i.e., the transaction involves a two party payment), staff's historic view has been to regard the payment as a reduction in the retailer's cost of goods sold. In this situation, the retailer and its direct vendor are free to negotiate the selling price of the property between them, which may consist of various types of cash discounts, volume rebates, quantity discounts, or promotional allowances.

5. A Reported Out-Of-State Decision Is Consistent With Staff's Approach.

Staff's version of proposed Regulation 1671.1 is consistent with the recent New Mexico Court of Appeals decision of *Grogan d/b/a Tobacco Patch v. New Mexico Taxation and Revenue Department* (2002) 2003 NMCA 33 [62 P.3d 1236], cert. denied (2003) 2003 N.M. Lexis 34. New Mexico's Court of Appeals found that a retailer was subject to New Mexico's sales tax on receipts from buy-down contracts with cigarette manufacturers because the contracts did not result in excludable cash discounts allowed to the taxpayer's customers. The buy-down contracts required the taxpayer to sell certain brands of cigarettes at a reduced price for a period of time specified by the manufacturers, and also required the taxpayer to advertise the price reduction in accordance with the manufacturer's instructions. In return, the taxpayer was compensated by the manufacturers for the loss in sales revenue resulting from the reduced sales price.

The circumstances involving the buy-down contracts in the New Mexico case appear nearly identical to the buy-down contracts previously encountered by staff. In that regard, the New Mexico Court found that: 1) the buy-down payments placed the retailer in the same position as if the retailer had sold the cigarettes at non-discounted prices; 2) the buy-down payments were intended by the Legislature to constitute gross receipts; and, 3) the retailer was not entitled to claim an exclusion from the gross receipts for cash discounts allowed and taken at the time of sale. In addition, the Court found that the imposition of the tax was on the retailer and that it was the retailer's decision as to how to compensate for that expense. A copy of the *Grogan* decision is attached to the Second Discussion Paper as Exhibit 2.

6. Buy-Down Rebates, As Defined In Proposed Regulation 1671.1, Constitute Gross Receipts.

Industry properly cites the relevant portions of Revenue and Taxation Code sections 6011 and 6012 regarding gross receipts and sales price, but misconstrues the meaning of those sections. Gross receipts mean "the total amount of the sale or lease or rental price, as the case may be, of the retail sales of retailers, valued in money or otherwise. . . ." (Rev. & Tax. Code, § 6012(a).) Industry asserts that the calculation of gross receipts is solely limited to the amounts the retailer collects from the purchaser. That approach, however, ignores the rationale of *Anders* and *Szabo* which provide that the total amount of the sale can include amounts paid by a third party. Staff does not dispute that the imposition of the sales tax does not occur until there is a retail sale requiring a transfer of title or possession of tangible personal property for consideration. (See Rev. & Tax. Code, §§ 6006(a), 6051.) Once a retail sale has occurred, however, the gross receipts from that sale is measured by the total amount received by the retailer which may include amounts collected from a third party source. Moreover, staff believes that the taxable "buy-downs" encountered to date constitute a "credit which is given to the purchaser by the seller" that is specifically part of gross receipts as set forth in Revenue and Taxation Code section 6012(b)(2). Again, when a retailer receives payment from a third party on the condition that the retailer reduce the selling price of specific property, that payment from the third party creates a credit that the retailer then provides to its customer as part of the underlying retail sale.

Industry is mistaken in its belief that "'Sales price', as defined in the Revenue and Taxation Code is the 'agreed to' price between buyer and seller, not some other price of which the purchaser is unaware." (See Cal-Tax 5/5/03 letter to C. Paliani, p. 2.) To the contrary, the definition of sales price[1] is nearly identical to the definition of gross receipts and, like gross receipts, is not limited to amounts solely provided by a purchaser. There is simply no language within Revenue and Taxation Code sections 6011(a) or 6012(a) that limits gross receipts or sales price to "the 'agreed to' price between buyer and seller" as suggested by industry.

[1] As noted above, sales price is the measure used for the imposition of tax on transactions subject to use tax.

7. The Board Presently Authorizes The Imposition of Tax on Amounts In Excess of A Stated Selling Price.

As noted in the Second Discussion Paper, this Agency already authorizes the calculation of tax or tax reimbursement on amounts different than the price advertised and charged to an end-use purchaser. For example, with manufacturer coupons, the price charged the customer is different than the amount upon which the measure of tax is calculated. (The measure of tax includes the amount paid by the customer plus the amount reimbursed to the retailer by the manufacturer upon redemption of the coupon.) In addition, Regulation 1585, *Cellular Phones, Pagers, and Other Wireless Telecommunication Devices*, imposes tax on the sale of "bundled" cellular telephone transactions measured by an amount that is different than the price advertised and paid by customers for that telephone. In a bundled transaction, a cellular telephone may be sold at a discounted or nominal price, but the retailer is still required to report and pay tax measured by a separately calculated "unbundled sales price" that is higher than the advertised or stated selling price. When this occurs, the retailer collects tax reimbursement from its customer based on an amount that is wholly separate from (and higher than) the stated selling price.

Staff believes that the imposition of tax on the buy-down receipts as specified in its version of proposed Regulation 1671.1 is no different. To the extent a buy-down amount is part of the retailer's gross receipts, that retailer may collect tax reimbursement from his or her customer measured by the amount collected from the customer and the specific buy-down amount received from the third party. To date, staff is unaware of any Business and Professions Code violations based on the collection of tax or tax reimbursement measured by amounts in excess of amounts paid by an end-use customer.

JT/bb
Attachment – May 19, 2003 Second Discussion Paper regarding Proposed Regulation 1671.1

HISTORY OF REBATES ISSUE

October 31, 2000 Business Taxes Committee (BTC)

The issue of buy-down rebates and incentive programs first arose in connection with the revisions to Audit Manual Chapter 9, *Grocers,* submitted to the BTC on October 31, 2000. Staff recommended the incorporation of new section 902.45, "Rebates and Incentives," which described the common rebate programs in use and the application of tax. An alternative, proposed by interested parties, provided that third party rebates would not be subject to tax unless the customer had knowledge that the retailer was receiving payments from other third parties. The BTC recommended that this issue be resolved by regulatory action rather than by a change in the Audit Manual, and the Board directed staff to proceed through the regulatory process using industry's proposal as a starting point and working with industry to develop language. The regulation was to be submitted on the Chief Counsel's Rulemaking Agenda, rather than as a BTC topic. Staff was also asked to determine the mix of industries that participate in buy-down rebate programs. In the meantime, audits were to be processed using current guidelines.

Status Reports

Proposed Regulation 1671.1 was removed numerous times by the Board from consideration on the Chief Counsel Matter calendar, partially due to the Board's direction to staff to research which industries, besides tobacco, would benefit from a change in the rebates policy. Staff provided status reports to the Board Members on January 31, 2001, February 14, 2001, and November 26, 2001. These status reports were prepared based on information obtained from the grocer industry and contacts with manufacturers from the paper goods, tobacco, beer, and soda industries. See Exhibit 4 for a copy of the November 26, 2001 status report.

Board Action

On April 18, 2002, two versions of the proposed regulation were presented to the Board for consideration. Staff's version incorporated the current policy and Industry's version incorporated the concept of customer knowledge. The Board authorized publication of proposed Regulation 1671.1, which incorporated industry's additional requirement of customer knowledge in order for the buy-down rebate to be taxable, and a proposed operative date of January 1, 2003. Industry's proposed regulation had an estimated revenue loss of at least $11-12 million in tax for cigarette rebates. A public hearing was scheduled for July 31, 2002, and subsequently rescheduled for September 11, 2002.

On September 11, 2002, the Board authorized publication of a third version which based the application of tax to a manufacturer's rebate, buy-down, etc. on whether the purchasing customer provides a coupon to the retailer. Where a coupon is redeemed by the customer, any amounts received by the retailer from a third party source would be includable in the retailer's gross

HISTORY OF REBATES ISSUE

receipts. The proposed operative date was July 1, 2002 for determinations and transactions occurring on or after that date, and August 1, 2002 for petitions and refund claims filed but not yet final as of August 1, 2002. A new public hearing was scheduled for December 18, 2002.

A new revenue estimate dated December 9, 2002 was provided to the Board Members, indicating that the adoption of the current version of proposed Regulation 1671.1 would result in a total revenue loss of $286 million, including $236 million from automobile manufacturer's rebates.

At the December 18, 2002 hearing, two motions were made, both of which failed:

1) Approve the regulation as is, including the non-taxation of rebates on vehicles sales; and

2) Table the regulation indefinitely.

In January 2003, proposed Regulation 1671.1, *Rebates and Incentives*, was scheduled as a topic for consideration by the Business Taxes Committee.

BOE-1586 REV. 1 (1-00)
BOARD STATUS REPORT

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

BOARD OF EQUALIZATION
STATUS REPORT

- ☐ Board Members
- ☐ Business Taxes Committee
- ☐ Customer Services and Administrative
- ☐ Legislative Committee
- ☐ Property Tax Committee
- ☒ Other [Insert Name]

Topic:

Update to the February 14, 2001 Status Report on the types of products involved in buy-down rebate programs.

Background:

On October 31, 2000, proposed revisions to Audit Manual Chapter 9, *Grocers*, were presented to the Business Taxes Committee for discussion. Included in the revisions was the creation of a new section explaining the application of tax to buy-down rebates and incentive programs. The Committee approved staff's recommendation to adopt and publish the proposed revisions to Audit Manual Chapter 9, except for section 0902.45, Rebates and Incentives. The Committee determined that it was not appropriate to make this change in the application of tax to buy-down rebates through the Audit Manual. Rather, the Committee directed staff to proceed through the regulatory process using industry's proposal as a starting point. Industry has proposed that the application of tax to rebates and incentives should be based on the customer's knowledge of the rebate program. In addition, staff was directed to work with interested parties to determine the mix and volume of products typically subject to buy-down rebate programs.

Staff provided two status reports to Board Members and interested parties, dated January 30, 2001 and February 14, 2001, summarizing the results of staff's research on the types of products involved in buy-down rebate programs. The status reports included information received from the grocery industry and contacts with manufacturers from the paper goods, tobacco, beer, and soda industries, as well as, information from the Department of Alcohol Beverage Control.

Proposed Regulation 1671.1, *Rebates and Incentives*, was scheduled for consideration as a Chief Counsel Matter at the February 15, 2001 Board meeting. Board Chair Honorable Claude Parrish requested that this matter be removed from the calendar in an effort to allow time to gather additional information on the types and volume of products that typically participate in buy-down rebate programs.

Staff met with interested parties on March 23, 2001, to discuss the buy-down rebate programs and again requested information to identify product types and volume of buy-down rebate programs. In attendance at this meeting were representatives from the California Grocers Association (CGA), California Independent Grocers Association, California Distributors Association, California/Nevada Soft Drink Association, Grocers Manufacturers Association, United Western Grocers, several supermarkets and grocery chains, and other industry representatives. The CGA expressed concern regarding the validity of the following information contained in staff's second status report: "Three out of four of the top tobacco manufacturers have provided annual buy-down rebate disbursements to California retailers for 2000, totaling $66,128,112," which reflects approximately two-thirds of the tobacco revenue impact. The CGA felt this amount was overstated and not representative. In addition, an interested party thought that the home improvement industry also had rebate programs that would qualify as buy-down rebate programs.

In response to these concerns, staff contacted the three tobacco manufacturers to again verify the manner in which the numbers were compiled. All three tobacco manufacturers queried their computer databases to compile amounts for all California retailers that were issued rebate disbursements for 2000. One manufacturer excluded all grocery chains since some locations may be out-of-state with one check issued to the headquarter office. This manufacturer felt the amounts provided were conservative. On the other hand, another manufacturer indicated that some distributor/retailers might have been included, but that the dollar amount of the rebate disbursements to this type of entity was not significant. The third manufacturer indicated that the distibutor/retailer category was excluded. Considering these variances, staff feels that the $66,128,112 in rebate disbursements provided by cigarette manufacturers for the year 2000 is a fairly accurate representation of the tobacco industry, considering the parameters involved. The variances noted by the tobacco industry are essentially offsetting and appear to result in a conservative estimate.

Staff contacted the merchandising and accounting departments of a chain of warehouse-type home improvement retail stores ("home improvement store") in order to learn about the prevalence of buy-down rebates in this industry. The home improvement store indicated that 99% of their purchases are made directly from manufacturers and that they do not allow manufacturers to dictate selling prices. Based on this information, staff has concluded that any participation by the home improvement industry in taxable buy-down rebate programs is likely to be minimal at best.

Since the interested party meeting on March 23, 2001, staff has been contacted by the CGA, which has been working with its members to obtain the necessary rebate information to present for verification. The CGA provided samples of documents believed to be agreements between the retailer and manufacturers regarding retailer rebate allowances. However, most do not indicate whether a price reduction is required. These documents referenced the following manufacturers: Eastman Kodak Company, Eveready, Proctor & Gamble, American Medical, Kimberly Clark, and various wine manufacturers.

Staff conducted additional research at the request of Board Chair Honorable Claude Parrish, who removed the issue from the May 8, 2001 Chief Counsel Matter agenda. Mr. Parrish asked staff to review the taxability of rebate programs in the automobile industry. In response, staff provided all interested parties, including automobile manufacturers and dealers, with amendments to industry's proposed rebate regulation that incorporated new subdivision (e)(3) on the Board's current policy regarding the taxability of "factory to dealer incentives" specific to the automobile industry. Staff

personally contacted representatives of the California Motor Car Dealers Association and the Alliance of Automobile Manufacturers who stated their intention to circulate the draft among their membership for comments. Staff received no responses either in support or opposition to the new subdivision (e)(3).

Current Status:

Staff is submitting its version of proposed Regulation 1671.1, *Rebates and Incentives,* for consideration at the December 20, 2001 Board meeting in Sacramento as a Chief Counsel Matter. In determining the taxability of rebate programs, staff's version requires two conditions that are stated in subdivsion (d)(1) and (d)(2), which reflects current Board policy. Staff's version requires that the buy-down rebate program involve a three party transaction and that the manufacturer require a reduction in the product selling price. Staff's version does not require that the customer has knowledge that the manufacturer will reimburse the retailer for the specified price reduction. Industry, on the other hand, recommends considering customer knowledge as a condition, which they propose as subdivision (d)(3). The examples in subdivision (e)(1) and (e)(2) are also different in the two proposed versions of the regulation since they explain the application of tax to the conditions set forth in subdivision (d). (See Exhibit 1 for industry's version.)

The information received to date shows that currently only manufacturers of cigarettes participate in buy-down rebates in California. No other industry besides the tobacco industry has been confirmed to be currently participating in taxable buy-down rebate programs. The following is a summary of the information obtained:

- Only one retailer has provided a sample buy-down rebate agreement. This buy-down rebate agreement, which involved Pepsi Bottling Group, had requirements for feature ads, display locations, and product price reductions to not exceed specified selling prices. Although a price reduction was present, it could not be determined whether the transaction was a two or three party transaction.
- The California/Nevada Soft Drink Association indicated that its members who are bottlers are also the manufacturers of the product. Therefore, rebate income derived from these two party transactions would not be considered additional gross receipts.
- Representatives of Pepsi-Cola and Coca-Cola have indicated that buy-down rebate programs have not been a common practice in the last two years.
- In fiscal year 1999-2000, out of 48 grocery store audits that assessed rebate income, only one was found to include soda buy-down rebates. All other assessments were for cigarette buy-down rebates.
- Three out of four of the top tobacco manufacturers have provided annual buy-down rebate disbursements to California retailers for 2000, totaling $66,128,112.
- The CGA has indicated that the alcoholic beverage industry participates in buy-down rebate programs. However, staff has learned from beer manufacturers and the Department of Alcoholic Beverage Control that such buy-down rebate programs for beer are prohibited by Business and Professions Code section 25000. This code section provides that beer manufacturers are not allowed to give retailers anything of value other than manufacturer

coupons. Liquor and wine manufacturers do not appear to be under similar pricing restrictions.

- The CGA's report of rebates on numerous other general merchandise products has not been confirmed since the general merchandise manufacturers contacted to date have indicated that they do not participate in buy-down rebate programs.
- The rebate programs offered in the automobile industry are not buy-down rebate programs, but rather manufacturer rebates that are taxable gross receipts, since the rebate is provided to the customer, who may then assign the rebate to the dealer for an adjustment to the down payment.

Conclusion:

In summary, staff has not been able to confirm that the version of Regulation 1671.1, *Rebates and Incentives* proposed by industry, will benefit any industries other than the tobacco industry and, to a minor extent, the soda industry. No information on buy-down revenues was provided or confirmed by the other industry manufacturers contacted. For more information on the potential revenue impact, see the report from the Research and Statistics Section provided with the February 14, 2001 Status Report, reproduced herein as Exhibit 2.

Prepared by: Program Planning Division, Sales and Use Tax Department

Current as of: November 26, 2001

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State of California

Board of Equalization
Agency Planning and Research Division

M e m o r a n d u m

To : Mr. Ramon Hirsig
Sales and Use Tax Department

Date : February 13, 2001

From : David Hayes
Research and Statistics Section

Subject : Buy-Down Rebates

In October 2000, in conjunction with an issue paper on proposed revisions to Audit Manual Chapter 9 – Grocers, the Research and Statistics Section prepared a revenue estimate on the proposal to provide that rebates issued by manufacturers or other third parties are in reality volume discounts and not includable in gross receipts. At that time, the only information that we were able to discover concerned such rebates on cigarettes. Board members requested information regarding any products other than cigarettes for which such rebates are offered.

Summary

In October 2000, we estimated that annual manufacturers' rebates on cigarettes amounted to $91.4 million annually. This estimate was based on information from a number of Board audits and from information from a few retailers. Further research confirms that estimate.

Information regarding buy-down rebates on other products has been difficult to obtain. The California Grocers Association (CGA) provided us a general product list of items on which such rebates might be offered, but did not include any information on the volume of the rebates. They also provided information from two of their members that indicate that they received rebates on detergents, paper products, carbonated soft drinks and alcoholic beverages in addition to rebates on tobacco products. The only information on the volume of such rebates was for alcoholic beverages and that was for only one business.

We have found little information to confirm the information provided by the CGA on rebates on products other than cigarettes. Soft drink manufacturers have indicated that they either never offered such rebates or no longer do so. Manufacturers of paper products and detergents indicated that they do not offer such rebates. It also appears that California law prohibits these types of rebates on at least some alcoholic beverages. An analysis of recent audits of grocery stores revealed that in 48 of the 395 audits analyzed, cigarette rebates were an issue. Rebates on products other than cigarettes were found in only one audit. This was for soft drinks and was a very small amount.

Our research indicates that there may be some rebates offered on products other than cigarettes. However, information regarding the volume of these rebates has not been forthcoming, either from retailers or from manufacturers. Additionally, there does not appear

to be any confusion for retailers on the taxability of these rebates, as evidenced by audit findings.

Tobacco Products

In our original estimate of buy-down rebates on cigarettes, we estimated that annual rebates on cigarettes amounted to $91.4 million. The sales and use tax revenue on these rebates at an effective tax rate of 7.92% amounted to $7.2 million. Research done since that estimate confirms that the estimate was, if anything, conservative.

Rebates on cigarettes have caused a significant amount of audit findings. An analysis of recent audits of grocery stores revealed 48 audits that assessed $1,944,398 in sales and use tax on buy-down rebates for cigarettes.

The Sales and Use Tax Department (SUTD) contacted tobacco manufacturers requesting information on their buy-down rebate programs. Information provided by tobacco manufacturers that command 45% of the cigarette market shows that they issued $66 million in rebate disbursements to California retailers during calendar year 2000. SUTD is still hoping to get similar information from other tobacco manufacturers.

If we assume that the other tobacco manufacturers had similar rebate programs, then the total disbursements of rebates to California retailers would amount to $146.7 million. ($66 million / 45% = $146.7 million.) The sales and use tax revenue on this amount would be $12.3 million.

Other Products

The California Grocers Association (CGA) provided us with the following list of products that might be subject to buy-down rebates.

Alcoholic Beverages
General Merchandise:
    Film, cameras, batteries, light bulbs, household cleaning products, etc.
Health Care & Personal Care:
    Oral care, pain relief, vitamins, deodorant, cosmetics, skin care, etc.
Soft Drinks
Tobacco Products

The CGA also provided the following information from two large supermarket chain members. The two members' sales and buy-down rebate revenues represent an analysis of a current 12-month period. The products listed are examples and not a complete listing of all product categories that routinely participate in buy-down rebate programs. The members felt that the listings provided indicate that tobacco products are not the leader with respect to the buy-down rebate revenues they have received. Following is the information that was provided.

Company A disclosed their sales of four product categories as a factor to tobacco sales so as not to disclose their actual sales revenues. The numbers indicate that carbonated beverage sales are five times the volume of tobacco sales and paper sales are twice the tobacco sales. They also indicate that detergent sales are a bit more than one and one half times the tobacco sales. Company A also provided figures on rebates as a percentage of product sales:

	Sales as a Factor to Tobacco Sales	Rebates as a Percentage of Product Sales
Tobacco	1.0	5%
Detergents	1.6	8-14%
Paper	2.0	10-12%
Carbonated Soft Drinks	5.0	8-9%

Company B provided actual sales revenues but for only two product categories, tobacco and alcoholic beverages:

	Actual Sales	Rebates Received
Tobacco	$21,000,000	$170,000
Alcoholic Beverages	$169,000,000	$4,000,000

These figures would indicate sizeable rebates are being paid by manufacturers on products other than cigarettes. The above information indicates that at least for these grocery stores, rebates for cigarettes amount to only about 5% of the total rebates they receive. Information from the Roswell Park Cancer Institute shows that 22% of cigarettes are sold in super markets. If we assume that this same percentage holds for rebates, then 22% of the estimated $91.4 million in rebates would be disbursed to super markets. This amounts to $20.1 million. If we further assume that cigarette rebates account for 5% of the rebates given to super markets, then total rebates at super markets would amount to $402 million, $20.1 million for cigarettes and $381.9 million for other products. The sales and use tax revenue on this $381.9 million in rebates for products other than cigarettes amounts to $30.2 million. If the rebate information given by the CGA does not include all rebates, then the revenue loss would be greater.

There does seem to be some question regarding the rebates on alcoholic beverages as reported by Company B. The Department of Alcoholic Beverage Control has informed us that pursuant to Section 25000 of the California Business and Professions Code, manufacturers of beer are prohibited from giving anything of value to retailers. This would preclude beer manufacturers from engaging in rebate programs. This would indicate that there is some confusion regarding the type of rebates under discussion. Rather than buy-down rebates, manufacturers of alcoholic beverages have programs of paperless coupons, called “scan-back” programs. This “scan-back” program is similar to manufacturer’s coupons with signs posted to alert consumers of the program rather than paper coupons. The discount is given when the item is scanned by the cash register. This type of coupon program would not be subject to the new tax application on rebates found in proposed Regulation 1671.1.

In an effort to verify the rebate figures supplied by the CGA, SUTD contacted the following manufacturers:

Coca-Cola Company
Pepsi-Cola Bottling Company
Seagram and Sons, Inc
Coors Brewing Company
Anheuser-Busch Companies Inc
General Mills, Inc
Proctor & Gamble Distributing Company
Kimberly-Clark Corporation

None of these manufacturers have as yet provided any information on the volume of buy-down rebate programs. Most have not even stated whether or not they engage in such programs. However, both Proctor & Gamble and Kimberly-Clark have stated that they did not offer such rebate programs.

An analysis of recent audits of grocery stores found only one audit in which buy-down rebates on a product other than cigarettes was an issue. The amount at issue was just over $1,000. This is a very small amount compared to the $1.9 million in cigarette rebates included in audits. It appears that to whatever extent there are buy-down rebates on products other than cigarettes there is no problem with the application of tax on these items.

Conclusion

Based on the above information it is quite clear that buy-down rebates on cigarettes amount to at least the $91.4 million estimated in October 2000. What is not so clear is the prevalence of such rebates on products other than cigarettes. While some information has been supplied by the California Grocers Association, staff has been unable to verify this information, either in contacts with manufacturers or from information on audits of grocery stores. The information we have received to date has been insufficient to develop a complete picture of buy-down rebates in California.

DEH:ap

cc: Ms. Laurie Frost
Ms. Charlotte Paliani

BOARD OF EQUALIZATION

BUSINESS TAXES COMMITTEE MEETING MINUTES

HONORABLE ERNEST J. DRONENBRUG, JR., COMMITTEE CHAIR
5901 GREEN VALLEY CIRCLE, CULVER CITY
OCTOBER 28, 1997 - 9:00 A.M.

Agenda Item: Grocery Store Discount Cards and Coupons

Issue

Whether discounts provided through the use of grocery store discount cards should be taxable, in part, as similar to manufacturer's coupons or should be excluded from taxable gross receipts similar to retailer's coupons.

Committee Discussion

Staff explained that since the last Business Taxes Committee meeting a review of the contractual relationship between grocery retailers and manufacturers in the discount card program was made. Staff found that reimbursements paid by manufacturers to grocery retailers are in some cases joint marketing agreements requiring specific performance on the part of the retailer in advertising campaigns. Staff further explained that this joint marketing arrangement is distinguishable from traditional manufacturers' coupons issued directly to consumers where the retailer is a third party in the transaction and obtains the face value of the coupon from the manufacturer.

Committee Action/Recommendation

The committee accepted the staff recommendation.

FORMAL ISSUE PAPER
(Rev. 10-97)

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

Issue Paper Number 97-018

☐ Board Meeting
☐ Business Taxes Committee
☐ Customer Services Committee
☐ Legislative Committee
☐ Property Tax Committee
☐ Other

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

GROCERY STORE DISCOUNT CARDS AND COUPONS

I. Issue

Should discounts provided through the use of grocery store discount cards be taxable, in part, similar to manufacturer's coupons or should they be excluded from taxable gross receipts similar to retailer's coupons.

II. Staff Recommendation

It is the staffs recommendation that tax should not apply to discounts obtained by using grocery store discount cards because they are similar to retailer’s coupons and that tax should remain applicable to manufacturer's coupons because the retailer receives the face value of such coupons in connection with their sale of tangible personal property.

III. Other Alternatives Considered

The amounts grocery retailers receive in connection with manufacturer's coupons should also be excluded from taxable gross receipts.

IV. Background

In general, the sales tax is imposed on retailers for the privilege of selling tangible personal property at retail. The sales tax is measured by the gross receipts of any retailer from the sale of tangible personal property at retail in this state. Revenue and Taxation Code Section 6012 defines gross receipts to mean the total amount of the sale or lease or rental price, as the case may be, of the retail sales of retailers, valued in money, whether received in money or otherwise. However, the definition, in part, also explains that gross receipts do not include cash discounts allowed and taken on sales. The discussion below applies to taxable sales of tangible personal property (as opposed, e.g., to exempt sales of food where the use of coupons is not relevant to the application of tax).

According to Webster's New World Dictionary, "coupons" are defined as certificates or tickets entitling the holder to a specified right, such as, redemption for cash or gifts, reduced purchase price, etc. With respect to retail sales, product coupons are commonly used by consumers to receive a reduction in the out-of-pocket purchase price of a specific product(s) based on a stated value on the face of the coupon, free merchandise, or a combination thereof. There are many types of coupon redemption plans used by retailers and manufacturers today to advertise, generate sales, and promote new and established products. They generally fall into two categories: manufacturer's coupons where the retailers receive the face value of the coupon from a third party; and retailer's coupons where the retailer does not receive any amounts in connection with the coupon from a third party.

When a consumer purchases merchandise with either a retailer's or a manufacturer's coupon, the purchaser presents the coupon plus a reduced net amount payable in exchange for the merchandise. That is, the consumer pays the shelf price less the face value of the coupon. However, whether the retailer receives any amount in addition to the net amount paid by the consumer for the sale of the merchandise depends on whether the coupon is a retailer's coupon or a manufacturer's coupon.

When the reduced price paid by the consumer is based on a retailer's coupon, the total amount received by the retailer in connection with the sale is the net amount paid by the consumer; the retailer receives no additional amounts in connection with the sale from any third party. Thus, the Board long-standing interpretation is that the face value of such coupons are not additional gross receipts, but rather are non-taxable discounts. Sales tax applies to the actual amount the retailer receives in connection with the sale, that is, the net selling price of the merchandise after the discount.

However, a manufacturer's coupon has a specific cash value to the retailer. The coupon is "perfected" by the retailer's taking the coupon in connection with the sale of the product in question. That is, the purchaser is tendering cash *plus* a coupon with a. specific cash value to the retailer. Thus, when a retailer receives a manufacturer's coupon in connection with a sale of tangible personal property, the retailer receives an amount from the purchaser (the "shelf' price less the face value of the discount) and also receives the face value of the coupon from

the manufacturer (often through the mechanism of a clearing house). This means that the retailer receives the amount of the shelf price in connection with the sale, consisting of the amount received from the purchaser and the amount received from the manufacturer's coupon. As with retailer's coupons, sales tax applies to the actual amounts the retailer receives in connection with the sale. Thus, the Board's long-standing interpretation is that Revenue and Taxation Code section 6012 requires that the face amount of manufacturer's coupons be included in the retailer's taxable gross receipts because the retailer actually receives such amounts in connection with the sale.

Manufacturer's coupons typically include some variation of the following statement:

> "The manufacturer will pay retailer for face value of coupon (up to the retail value of product) plus 8 cents provided retailer and consumer have complied with offer. Void where prohibited, taxed or restricted by law. Coupons have no cash value without simultaneous purchase. Consumer pays any sales tax including sales tax for 'free products'. Invoices proving product purchase to cover coupons must be available from retailer."

This shows that the coupon represents a right of the retailer to collect the face value of the coupon from the manufacturer and a promise by the manufacturer to the consumer that the coupon value will be paid to the retailer. That is, at the time of the sale transaction, the coupon has a cash value to the retailer, and the retailer actually receives that cash value because it made the sale. The face value of the coupon is not merely a reduction of the cost of goods to the retailer because the payment of such amounts to the retailer is not solely a matter between the retailer and the manufacturer, but rather is based on the contract of sale from the retailer to its purchaser and the redemption of a coupon which is given value by virtue of that sale.

Discussion of the Issue

With the growing trend to utilize advancing technology and the desire to automate manual processes, certain major grocery store chains have established electronic discount card systems. Grocery store discount cards provide convenience to consumers by relieving them from having to clip and carry paper coupons to present at the time of purchase, but which may entitle the cardholder to discounts that are similar to those that can be obtained by using paper coupons. In sample discount booklets reviewed by staff, the grocers have offered parallel mechanisms which give the consumers the option of using printed coupons to obtain discounts or using grocery store discount cards to obtain similar discounts. When the consumer uses a discount card, the appropriate discount is recognized and recorded electronically at the cash register. There is no coupon handed to the retailer as part of the sale transaction, and there is no definitive and ascertainable amount for which a manufacturer is obligated to pay the retailer solely by virtue of the retailer's acceptance of the coupon as part of the sale transaction.

Most large grocery chains purchase their goods directly from manufacturers and have the items shipped to their own distribution centers for subsequent delivery to stores. Smaller retailers on the other hand most frequently acquire inventory from distributors and do not have a direct contractual relationship with the manufacturers with respect to the products the

small retailers sell. Whether the grocery chain is large or small, manufacturer's paper coupons are most often redeemed through the use of an intermediary clearing house, and not directly from the manufacturer on whose behalf the coupon was issued. As such, the payment of the face value of a manufacturer's coupon to the retailer is not a reduction in the cost of goods. In the case of a retailer who does not purchase its merchandise directly from the manufacturer, it is not possible for the redemption of a manufacturer's coupon to constitute a reduction in the cost of goods to the retailer since the person paying that amount, the manufacturer, is a different person than the seller of the goods to the retailer. For these reasons, manufacturer's coupons are taxable gross receipts to the retailer under section 6012, whether or not the retailer has an independent contractual relationship with the manufacturer, and are not reductions in the cost of goods.

With the advent *of* grocery store discount cards, retailers continue to redeem manufacturer's coupons through traditional clearing houses. Independent but parallel to that system are advertising allowances that retailers receive in connection with their sales volume recognized through the discount card system. Unlike manufacturer’s coupons pursuant to which the retailer obtains the right to receive additional gross receipts from the manufacturer based on the face value of the coupon received in exchange for the sale of the tangible personal property, the discount allowed to the consumer under the discount card program is not predicted on a manufacturer’s promise to reimburse. Rather, any payment made by the manufacturer to the retailer is based on a contract solely between the retailer and the manufacturer for incurred by the retailer to advertise the manufacturer's products, based on the volume of the manufacturer's products sold by the retailer. The consumer is not aware of the discount and advertising reimbursement arrangement.

V. Staff Recommendation

A. Description

Staff recommends that the redeemed value of manufacturer's coupons remain includable in gross receipts since the retailer has the right to receive such amounts based on the retailer's acceptance of the manufacturer's coupon in exchange for the sale of tangible personal property. Staff believes that a change in this long- standing interpretation would require legislative amendments to section 6012.

Staff recommends that the discount allowed based on the retailer's own coupons continue to be regarded as non-taxable discounts because the retailer receives no amounts from the consumer or third parties in connection with such coupons.

Staff further recommends that discounts allowed to consumers using grocery store discount cards be regarded as non-taxable discounts similar to retailer’s discount coupons since the right to the discount is based solely on the relationship between the retailer and its purchaser and not on the tender of a manufacturer’s coupon that has a specific face value redeemable by the retailer. Although the retailer may obtain some reimbursement from the manufacturer in connection with its discount card program, such payments do not involve the customer and are based solely on

contractual provisions between the retailer and the manufacturer for advertising allowances.

B. Pros of Staff Recommendation

- This recommendation eliminates confusion in this area for consumers and grocers.
- This recommendation does not require legislative action or revision to existing regulation.
- This recommendation eases the cash register programming, record keeping and tax reporting burden for grocers.

C. Cons of Staff Recommendation

- None.

D. Statutory or Regulatory Change

None. The staff recommendation is the current method of reporting.

E. Administrative Impact

None.

F. Fiscal Impact

There is no anticipated cost or revenue impact.

G. Taxpayer/Customer Impact

None.

H. Critical Time Frames

None.

VI. Alternative

A. Description

Manufacturer's coupons redeemed by grocery stores should be treated the same as retailer's coupons and the reimbursement received by grocers from manufacturers for the face value of redeemed coupons excluded from the measure of tax.

B. Pros of Alternative

- This proposal would provide a reduced tax liability for grocers.
- This proposal provides a consistent application of tax to sales with discounts given at the cash register regardless of the source.
- This proposal eases record keeping and tax reporting burden for grocers.

C. Cons of Alternative

- Requires legislative change.
- May encourage solicitation for similar provisions for coupons and rebate programs in other retailing industries.
- Affected taxpayers may be required to reprogram their cash registers to ensure tax is not calculated on amounts related to manufacturer's coupons.

D. Statutory or Regulatory Change

Revenue and Taxation Code Section 6012 provides that, "'Gross receipts' means the total amount of the sale or lease or rental price, as the case may be, of the retail sale of retailers, valued in money, whether received in money or otherwise . . . The total amount of the sale or lease or rental price includes all of the following: . . .(2) All receipts, cash, credits and property of any kind. (3) Any amount for which credit is allowed by the seller to the purchaser. . . ." These provisions have been interpreted to mean that taxable gross receipts include amounts paid to retailers for the manufacturer's coupons they accept as part of the sale of tangible personal property.

The adoption of this alternative would require legislation to exclude from gross receipts amounts related to manufacturer's coupons. Legislation would also be required to limit this exclusion to coupons redeemed only at grocery stores.

E. Administrative Impact

None.

F. Fiscal Impact

- Costs should be absorbable.
- Revenue Impact - Please see attached revenue estimate.

G. Taxpayer/Customer Impact

Grocers' tax liabilities would be reduced.

H. Critical Time Frames

This issue is not critical, but should be addressed as expeditiously as possible to prevent errors in tax reimbursement and reporting.

Prepared by: The Sales and Use Tax Department
Program Planning Division

Current as of October 17, 1997

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

BOARD OF EQUALIZATION
REVENUE ESTIMATE

GROCERY STORE DISCOUNT CARDS AND COUPONS

Alternative Proposal

Whether manufacturer's coupons redeemed at grocery stores should be excluded from gross receipts similar to retailer's coupons.

Background, Methodology, and Assumptions

According to a May 1997 article in the Detroit News, a recent study has found that more than 70 percent of all consumers use manufacturer's coupons at grocery stores each year, saving $4.8 billion annually. This same $4.8 billion figure was quoted in an article copyrighted by the Knight-Ridder/Tribune News Service here in California. If $4.8 billion in manufacturer's coupons are being redeemed annually nationwide, and if California represents 12% of this total, the percentage California represents of the total US population, then California grocery stores are receiving $576 million in such coupons each year.

Based on information from sales tax audits and from information published by Progressive Grocer magazine, about 30% of these coupons are being used for taxable sales. That would mean that $172.8 million in manufacturer's coupons are being received in California each year towards the payment for taxable sales. ($576 million x .3 = $172.8 million)

Revenue Estimate

The revenue impact from excluding the $172.8 million in manufacturer's coupons received by grocery stores from the measure of tax for sales and use tax purposes would be as follows:

	Revenue Effect
State loss (5%)	$ 8.6 million
Local loss (2.25%)	3.9 million
Transit loss (0.64%)	1.1 million
Total	$13.6 million

Preparation

This revenue estimate was prepared by David E. Hayes, Statistics Section, Agency Planning and Research Division. This revenue estimate was reviewed by Mr. Jeff Reynolds, Manager, Statistics Section, Agency Planning and Research Division and Mr. Dennis Fox, Program Planning Manager, Sales and Use Tax Department. For additional information, please contact Mr. Hayes at (916) 445-0840.

Current as of October 17, 1997

Business Taxes Committee Meeting

Discussion Item

October 7, 1997

Topic: GROCERY STORE DISCOUNT CARDS AND COUPONS

A major grocery store chain has approach staff with questions regarding electronic discount cards and coupons now in use by many large chain grocery retailers. Electronic coupons are rapidly replacing the traditional paper coupons. With the trend to utilize advancing technology and the desire to automate manual processes, it is not surprising that a "paperless coupon" system has come to existence. Grocery store discount cards provide convenience to consumers by relieving them from having to clip and carry paper coupons to present at the time of purchase. Instead, the consumer presents a store card issued to them by the retailer which entitles the cardholder to discounts on purchases for which the retailer mayor may not have issued paper coupons.

Through use of the card, the discounts attributable to the merchandise purchased are recognized electronically at the cash register. While a physical coupon is not presented by the consumer to the retailer, the grocery store discount card acts as a symbolic representative of *both* manufacturer and retailer coupons which would have been furnished otherwise. Retailers receive reimbursement from manufacturers based on sales oflhe manufacturer's proprietary products similar in manner to the redemption of manufacturer's paper coupons. As a result, it is necessary for retailers to segregate these transactions and calculate the amount of tax reimbursement accordingly.

Industry has asked if our historical coupon rules apply in an electronic environment and the basis for drawing a tax distinction between manufacturers and retailers coupons.

In general, the sales tax is imposed on retailers for the privilege of selling tangible personal property at retail. The sales tax is measured by the gross receipts of any retailer from the sale of tangible personal property at retail in this state. Revenue and Taxation Code Section 6012 defines gross receipts to mean the total amount of the sale or lease or rental price, as the case may be, of the retail sales of retailers, valued in money, whether received in money or otherwise. The definition, in part, also explains that gross receipts do not include cash discounts allowed and taken on sales.

While the Board has not previously considered the issue of grocery store discount cards, it has routinely addressed a similar system as we know involving discount coupons. According to Webster's New World Dictionary, "coupons" are defined as certificates or tickets entitling the holder to a specified right, such as, redemption for cash or gifts, reduced purchase price, etc. With respect to retail sales, product coupons are commonly used by consumers to receive a reduction in the out-of-pocket purchase price of a specific product(s) based on a stated value on the face of the coupon, free merchandise, or a combination thereof. There are many types of coupon redemption plans used by retailers and manufacturers today to advertise, generate sales and promote new and established products while providing a lower cost for merchandise to

consumers. They generally fall into two categories: coupons issued or published by retailers, and those issued or published by product manufacturers.

Tax Applies to "gross receipts" derived by the grocer from the retail sales of taxable products. In the case of a retailer's coupon, all that the grocer receives is the payment actually made by the customer. The coupon amount is regarded as a discount. In the case of a manufacturer's coupon, the situation is different. As a result of the sale occurring, the grocer receives two amounts. It receives the amount paid by the customer and the cash amount which it derives from the manufacturer. There has been no reduction in the price of the goods. There has been no reduction in the amount received by the grocer. It is staff's view that any credit given to the grocer in such circumstances would remain includable in gross receipts, because the credit is earned as a result of the sale and "gross receipts" includes any amount for which credit is allowed by the seller to the purchaser.

This position is reflected in the Sales and Use Tax annotations. Annotation 280.0700, September 12, 1967, states that, "The redemption value of a coupon distributed by a manufacturer to a consumer, which is redeemed by a local retailer for the manufacturer's product, constitutes taxable gross receipts from the sale of the product, where the retailer will be reimbursed the price of the product by the manufacturer." In this case, the price of the product was the value of the coupon. Annotation 295.0430, May 9, 1973, states, "Amounts paid by a manufacturer to a retailer in redemption of coupons pursuant to an agreement permitting the retailer to publish the coupons in newspapers and handbill advertisements to be used by the retailer's customers in purchasing the product of the manufacturer, are includable in the retailer's gross receipts."

In addition to basic manufacturer's and retailer's coupons, there are a variety of promotional and discount programs available to consumers that either augment or substitute the traditional coupon system. These programs may represent consumer incentives offered by retailers, manufacturers, or a combination thereof. A couple of combination examples are "double discount coupons" and "grocery store discount cards."

The offering of double discount coupons is a consumer incentive program in which the retailer matches the value of a manufacturer coupon at the time the consumer makes a purchase and provides the consumer twice the discount of the coupon face value. In this instance, it is recognized that half of the discount is attributable to the manufacturer's coupon and the other half is attributable to a discount provided by the retailer. Consistent with the general rules that apply, staff has recognized the retailer discount as a true cash discount and have excluded that amount from taxable gross receipts. However, the original face value of the manufacturer's coupon remains a part of the taxable consideration of the sale. This scenario requires additional programming efforts to properly calculate the measure of tax since the tax treatment is different for retailer's and manufacturer's discounts.

Most large grocery chains purchase their goods directly from manufacturers and have the items shipped to distribution centers for subsequent delivery to stores. Smaller retailers on the other hand most frequently acquire inventory from distributors. Historically grocery stores redeem manufacturer's paper coupons, not from the manufacturer directly, but through intermediary service companies (clearing houses). With the advent of electronic coupons, retailers are redeeming coupons through the traditional clearing houses and directly with the manufacturers.

If the electronic coupon program is substantially similar to the paper coupon redemption process, staff would have to recommend the tax treatment be consistent with the traditional paper coupon redemption system. In other words, if the rebate is based solely on the number of products sold, not based on the amount of merchandise purchased by the retailer or some other criteria, then grocers would be required to make the segregation in their records to properly account for manufacturers rebates. Staff did not have sufficient notice to fully examine the contractual relationship between the parties. Further analysis of the details may disclose that the rebates are more akin to purchase discounts or reimbursement for promotional activities, and as such may lead to a different conclusion.

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Proposed Regulation 1671.1. DISCOUNTS, COUPONS, REBATES AND OTHER INCENTIVES.

References: Sections 6011, 6012, Revenue and Taxation Code
Gifts, Marketing Aids, Premiums and Prizes generally, see Regulation 1670
Trading Stamps and Related Promotional Plans generally, see Regulation 1671

(a) IN GENERAL. Manufacturers, vendors, and other third parties often engage in various programs that result in credits or payments made to retailers with respect to a retailer's taxable sale of tangible personal property to an end-use customer. These payments and credits include, but are not limited to, purchase and cash discounts, coupon reimbursements, ad or rack allowances, buy-downs, scanbacks, voluntary price reductions and other incentives, promotions, and rebates. Under certain conditions, payments received by the retailer in the form of rebates or other types of payments or credits for products sold at retail are included in the retailer's gross receipts or sales price from the sale of the product.

(b) DISCOUNTS.

(1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. Generally, discounts provided to customers utilizing a grocery store discount club card are regarded as cash discounts or retailer coupons.

(2) PURCHASE DISCOUNTS are given by a vendor to that vendor's customer (i.e., a retailer) based upon the amount of prior purchases by that customer. The discounts are regarded as trade discounts and are not additional gross receipts.

(3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are not additional gross receipts. Generally, payments to a grocery store retailer pursuant to discounts offered through a grocery store discount club card are regarded as an ad or rack allowances.

(c) COUPONS.

(1) RETAILER COUPONS. A retailer may issue paper or paperless coupons which, when utilized by the purchaser, entitles the purchaser to buy tangible personal property at a certain amount or percentage off the advertised selling price. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the gross receipts from the sale. If, however, the customer has previously given compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts.

(2) MANUFACTURER'S COUPONS. A manufacturer may fund paper or paperless coupons that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. Amounts paid by a manufacturer to a retailer for the redemption of a coupon used for the purchase of the manufacturer's products are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer. Manufacturer's coupon programs may be known as "Coupon Redemptions," "Instant Rebates" or by a similar name.

(d) REBATES AND INCENTIVES. These are transactions involving buy-down programs, mark downs, discounts, coupons, rebates, and other price reductions. These rebate programs are also known as "Buy-Down Rebates," "Promotions," "Flex" (Flex Extensions), or by a similar name.

Revenue received by the retailer from these types of programs or other similar types of programs is part of the retailer's gross receipts from the sale to a consumer when both of the following conditions are met:

(1) The buy-down rebate or similar program involves a three party transaction. A three party transaction exists when the retailer, the vendor to the retailer, and the manufacturer or some other third party not directly selling tangible personal property to the retailer, are each separate legal entities. A "separate legal entity" is defined as an entity that is a person under Section 6005, such as a corporation, limited partnership, general partnership, or limited liability company. A three party transaction exists even when one party wholly owns another party. In situations where the manufacturer is also the vendor to the retailer, as one legal entity, and no other third party provides a buy down or other similar type of payment to the retailer, the three party requirement is not met.

(2) The manufacturer or other third party requires a reduction in the retailer's product selling price. A price reduction exists when the manufacturer or other third party requires, through a written or oral contract, the retailer to reduce the retailer's selling price of the product from the regular selling price. The price reduction can be a specific amount or a requirement to not exceed a specified reduced selling price. The fact that a retailer lowers a product's selling price and receives payment from a manufacturer or other third party should not be considered as the only evidence that the manufacturer or other third party required a reduction inhte retailer's product selling price.

Both of the conditions above must be met in order for rebate income to be considered part of the retailer's gross receipts. If both of the conditions are not met, the rebate income will be considered a purchase discount and not includable in the retailer's gross receipts.

(e) EXAMPLES.

(1) The following are examples of situations where payments received by the retailer from the manufacturer or other third party are part of the gross receipts from the sale of the product:

(A) Coupon on dog food bag says $2 off at register. Coupon indicates "Manufacturer's Coupon."

(B) The retailer purchases dog food from its vendor, a separate legal entity from the manufacturer. The manufacturer requires that the retailer reduce the selling price of the product by $2. The manufacturer will reimburse the retailer $2 for each item sold at the end of the promotional period. The manufacturer may issue the retailer a rebate check directly or pay the distributor on behalf of the retailer.

(2) The following are examples of situations where payments received by the retailer from the manufacturer or other third party are reductions to cost and not included in the retailer's gross receipts from the sale of the product:

(A) Coupon on the dog food bag says $2 off at register. There is no indication on the coupon, in a newspaper ad, at the rack, on the receipt, or anywhere else that the retailer will receive $2 from another person to compensate for the $2 price reduction. The coupon is regarded as a retailer's coupon provided the coupon is not otherwise a rebate or incentive described in subdivision (d).

(B) The manufacturer sells dog food direct to the retailer and also issues a rebate check at the end of a promotional period for the sale of the dog food at a reduced selling price. As part of the rebate program, the manufacturer requires that the retailers selling price may not exceed a stated amount. Since this is a two party transaction, the rebate payment to the retailer is regarded as a reduction of the purchase price and not as gross receipts from the sale of the product.

(C) The manufacturer issues a rebate check to the retailer for $2 for each bag of dog food sold during a promotional period without regard to the selling price of the product. The rebate program was based on the number of bags sold and not on the number of bags sold at a reduced selling price. The retailer purchases the products through its vendor, a separate legal entity. Without a required reduction in the selling price of the dog food, the rebate income is regarded as a reduction in the purchase price and not as gross receipts.

(3) The following are examples of situations involving payments by automobile manufacturers to automobile dealers or end-use customers with respect to the sale or lease of automobiles.

(A) An automobile manufacturer provides a customer with a $1,000 rebate upon the purchase of a specific automobile. Rather than receive payment from the manufacturer, the customer assigns the rebate to the dealer who in turn applies the amount of that rebate toward the customer's payment for the vehicle. The $1,000 payment by the manufacturer is part of the dealer's gross receipts, since the rebate is provided to the customer who uses the rebate amount to partially satisfy that customer's total payment obligation to the dealer. The $1,000 rebate does not constitute a reduction in the retailer's gross receipts as a retailer's coupon, cash discount, purchase discount, or otherwise.

(B) An automobile dealer receives a $500 incentive from the automobile manufacturer for every vehicle sold of a specific model in a given period. The manufacturer does not have an oral or written contract requiring the dealer to sell the specific model at a reduced price. The selling price is based solely on the dealer's discretion. Under these facts, the $500 payment by the manufacturer is not part of the dealer's gross receipts, since the manufacturer does not require a reduction in the retail selling price of the vehicle. The $500 incentive instead constitutes a reduction in the dealer's cost of goods sold.

Proposed Regulation 1671.1. DISCOUNTS, COUPONS, REBATES AND OTHER INCENTIVES.

References: Sections 6011, 6012, Revenue and Taxation Code
Gifts, Marketing Aids, Premiums and Prizes generally, see Regulation 1670
Trading Stamps and Related Promotional Plans generally, see Regulation 1671

(a) IN GENERAL. Manufacturers, vendors, and other third parties often engage in various programs that result in credits or payments made to retailers with respect to a retailer's taxable sale of tangible personal property to an end-use customer. These payments and credits include, but are not limited to, purchase and cash discounts, coupon reimbursements, ad or rack allowances, buy-downs, scanbacks, voluntary price reductions and other incentives, promotions, and rebates. Under certain conditions, payments received by the retailer in the form of rebates or other types of payments or credits for products sold at retail are included in the retailer's gross receipts or sales price from the sale of the product.

(b) DISCOUNTS.

(1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. Grocery store discount club cards are generally considered cash discounts.

(2) PURCHASE DISCOUNTS are given by a vendor to that vendor's customer (i.e., a retailer) based upon the amount of prior purchases by that customer. The discounts are regarded as trade discounts and are excluded from gross receipts.

(3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are excluded from gross receipts.

(c) COUPONS.

(1) RETAILER COUPONS. A retailer may issue paper or paperless coupons which, when presented to the retailer by the purchaser, entitles the purchaser to buy tangible personal property at a certain amount or percentage off the advertised selling price. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the gross receipts from the sale. If, however, the customer has previously given compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts.

(2) MANUFACTURER'S COUPONS. A manufacturer may fund paper or paperless coupons that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. Amounts paid by a manufacturer to a retailer for the redemption of a coupon used for the purchase of the manufacturer's products are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer.

(d) REBATES AND INCENTIVES. These are transactions involving buy-down programs, mark downs, discounts, coupons, rebates, and other price reductions. These rebate programs are also known as "Buy-Down Rebates," "Voluntary Price Reductions" "Promotions," "Flex" (Flex Extensions), "Coupon Redemptions," "Scanbacks," "Instant Rebates" or by a similar name.

Revenue received by the retailer from these types of programs or other similar types of programs is part of the retailer's gross receipts from the sale to a consumer when both of the following conditions are met:

(1) The manufacturer requires a reduction in the retailer's product selling price. A price reduction exists when the manufacturer requires, through a written or oral contract, the retailer to reduce the retailer's selling price of the product from the regular selling price. The price reduction can be a specific amount or a requirement to not exceed a specified reduced selling price. The fact that a retailer lowers his or her retail price and receives payment under a rebate program is not evidence that a contractual requirement exists to reduce the price as a condition for receiving payment.

(2) The customer has knowledge that the manufacturer will reimburse the retailer for the specified price reduction. The customer knowledge can be in the form of a receipt, sticker, sign, display or other indicator that the retailer will receive a payment from the manufacturer for a specific amount in return for a reduction in the selling price of the product.

Both conditions above must be met in order for rebate income to be considered part of the retailer's gross receipts. If all the conditions are not met, the rebate income will be considered a purchase discount and not includable in the retailer's gross receipts.

(e) EXAMPLES.

(1) The following are examples of situations where payments received by the retailer from the manufacturer are part of the gross receipts from the sale of the product:

(A) Coupon on dog food bag says $2 off at register. The coupon indicates "payable by Big Bad Dog Food Co. (BBDF Co.)" or "All promotional costs paid by BBDF Co."

(B) Coupon on dog food bag says $2 off at register. Newspaper ad, notice at rack, or on receipt or elsewhere says "$2 coupon payable by BBDF Co."

(C) The retailer purchases dog food from a distributor, a separate legal entity from the manufacturer (BBDF Co.). No coupon is present on the dog food bag. However, a newspaper ad or display notice states that a "price reduction is made possible by BBDF Co." and $2 is separately itemized on the retailer's receipt as the amount of price reduction.

(2) The following are examples of situations where payments received by the retailer from the manufacturer are reductions to cost and not included in the retailer's gross receipts from the sale of the product:

(A) Coupon on the dog food bag says $2 off at register. There is no indication on the coupon, in a newspaper ad, at the rack, on the receipt, or anywhere else that the retailer will receive $2 from another person to compensate for the $2 price reduction. The coupon is regarded as a retailer's coupon provided the coupon is not otherwise a rebate or incentive described in subdivision (d).

(B) Sign at display says "price reduction made possible by BBDF Co." Bag is priced at $10, but there is no indication in a newspaper ad, at the rack, on the receipt, or anywhere else of the amount of the price reduction.

(3) The following are examples of situations involving payments by automobile manufacturers to automobile dealers or end-use customers with respect to the sale or lease of automobiles.

(A) An automobile manufacturer provides a customer with a $1,000 rebate upon the purchase of a specific automobile. Rather than receive payment from the manufacturer, the customer assigns the rebate to the dealer who in turn applies the amount of that rebate toward the customer's payment for the vehicle. The $1,000 payment by the manufacturer is part of the dealer's gross receipts, since the rebate is provided to the customer who uses the rebate amount to partially satisfy that customer's total payment obligation to the dealer. The $1,000 rebate does not constitute a reduction in the retailer's gross receipts as a retailer's coupon, cash discount, purchase discount, or otherwise.

(B) An automobile dealer receives a $500 incentive from the automobile manufacturer for every vehicle sold of a specific model in a given period. The manufacturer does not have an oral or written contract requiring the dealer to sell the specific model at a reduced price. The selling price is based solely on the dealer's discretion. Under these facts, the $500 payment by the manufacturer is not part of the dealer's gross receipts, since the manufacturer does not require a reduction in the retail selling price of the vehicle. The $500 incentive instead constitutes a reduction in the dealer's cost of goods sold.

(f) OPERATIVE DATE.

(1) General Rule – The provisions of subdivision (d) shall apply to transactions that occur or petitions for redeterrmination filed but not yet final on or after the first day of the first quarter commencing after this regulation is approved by the Office of Administrative Law.

(2) Application to Pending Controversies.

A. The provisions of subdivision (d) shall apply to petitions for redermination filed but not yet final as of operative date in (f)(1).

B. The provisions of subdivision (d) shall apply to claims for refund filed but not yet final as of January 1, 2003.

2 of 2 DOCUMENTS

VICKI C. GROGAN, d/b/a TOBACCO PATCH, ID. No. 02-397117-00-7, Protestant-Appellant, v. NEW MEXICO TAXATION AND REVENUE DEPARTMENT, Respondent-Appellee.

Docket No. 22,552

COURT OF APPEALS OF NEW MEXICO

***2003 NMCA* 33; 62 *P.3d* 1236; *2002 N.M. App. LEX/S* 125**

December 11, 2002, Filed

SUBSEQUENT HISTORY:
[..1] Certiorari Denied, No. 27,856, January 31, 2003. Released for Publication February 6, 2003.

PRIOR HISTORY:
APPEAL FROM THE TAXATION AND REVENUE DEPARTMENT. Margaret B. Alcock, Hearing Officer.

DISPOSITION:
Hearing officer's decision and order affirmed.

CASE SUMMARY

PROCEDURAL POSTURE: Appellant taxpayer sought review of the decision of a New Mexico Taxation and Revenue Department hearing officer's decision and order upholding appellee New Mexico Taxation and Revenue Department's (department) gross receipts tax assessment against the taxpayer.

OVERVIEW: A hearing officer upheld the department's gross receipts tax assessment against the taxpayer's unreported receipts from "buy-down" contracts and "shelf-display" contracts with cigarette manufacturers. The taxpayer further appealed the department's assessment of a penalty for negligence. The court affirmed, stating that the buy-down contract payments were taxable because the payments constituted gross receipts under *NM. Stat. Ann. § 7-9-3(f)* (2002). The payments were reimbursements to the taxpayer for her sales loss incurred as a result of engaging in the discount promotions. Further, the court held that the shelf-display contract receipts were taxable because those contracts bore a much greater resemblance to a license than to the creation and conveyance of an interest in real property that would constitute a lease pursuant to *N.M. Stat. Ann. § 7-9-53(A)* (1998). The facts did not show sufficient dominion over and control of the property by the cigarette manufacturers to constitute a leasehold interest. The court concluded that the penalty assessment pursuant to *N.M. Stat. Ann. § 7-J-69(A)* (2001) was proper because the taxpayer's failure to pay the tax was negligent.

OUTCOME: The judgment was affirmed.

LexisNexis(TM) HEADNOTES -Core Concepts

Administrative Law> Judicial Review> Standards of Review> Standards Generally
[HN1] The Court of Appeals of New Mexico will set aside the decision and order of the hearing officer only if found to be: (1) arbitrary, capricious or an abuse of discretion; (2) not supported by substantial evidence in the record; or (3) otherwise not in accordance with the law. *N.M Stat. Ann. § 7-1-25(C)* (1989). The court reviews the evidence in the light most favorable to the New Mexico Taxation and Revenue Department's decision to determine whether the decision is supported by substantial evidence in the record as a whole. To the extent that the court's review involves interpretation of a statute, or the application of law to undisputed facts, the review is de novo.

Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
[HN2] There exists a statutory presumption that all receipts are taxable. *N.M. Stat. Ann.* § 7-9-5 (1966) (amended 2002). The taxpayer claiming that receipts are not taxable bears the burden of proving that assertion.

2003 NMCA 33, *; 62 P.3d 1236; 2002 N.M. App. LEXIS 125, **

Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
[HN3] The New Mexico Taxation and Revenue Department's assessment is presumed to be correct. *N.M. Stat. Ann. § 7-1-17(C)* (1992). The effect of the presumption of correctness is that the taxpayer has the burden of coming forward with some countervailing evidence tending to dispute the factual correctness of the assessment made by the secretary. Unsubstantiated statements that the assessment is incorrect cannot overcome the presumption of correctness. N.M. Admin. Code tit. 3, ch. I, pt. 6, § 12(A) (2001).

Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
[HN4] "Gross receipts" means the total amount of money or the value of other consideration received from selling property in New Mexico, or from performing services in New Mexico. *N.M Stat. Ann. § 7-9-3(F)* (2002)

Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
[HN5] "Gross receipts" excludes cash discounts allowed and taken. *NM Stat. Ann.* § 7-9-3 *(F) (1) (a)* (2002). This exclusion provides a tax exemption. When a taxpayer relies on an exemption, the Court of Appeals of New Mexico construes the statute the statute strictly in favor of the New Mexico Taxation and Revenue Department Taxation is the rule and the burden is on the taxpayer to bring itself within any claimed exception. Furthermore, the taxpayer must clearly establish the exemption. In addition, the right to the exemption must be clearly and unambiguously expressed in the statute.

Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
Governments> Legislation> Interpretation
[HN6] The New Mexico Taxation and Revenue Department's regulation based on the *NM Stat. Ann. § 7-9-3(F)(2)* (2002) exclusion reads: Discount coupons: The gross receipts attributable to a sale in which a seller accepts discount coupons provided by buyers are measured by the cash received plus the value of the coupon. However, if the discount coupon is not redeemable by the seller, the acceptance of the coupon constitutes a cash discount allowed and taken and is excluded from gross receipts. 3.2.1.14(1) NMAC 2002. This regulation is presumed to be a proper implementation of the statute. *NM Stat. Ann.* § 9-11-*6.2(G)* (1995), comparable provisions formerly *NM. Stat. Ann. § 7-1-5(G)* (repealed 1995). The regulation is entitled to substantial weight. The construction given a statute by the administrative agency charged with the enforcement of it is a significant factor to be considered by the courts in ascertaining the meaning of such statute.

Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
[HN7] A retailer who is reimbursed a discounted amount does not absorb the cash loss. Such a retailer is in no position to claim an exclusion involving taxes.

Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
[HN8] Every person is charged with the reasonable duty to ascertain the possible tax consequences of his action. Furthermore, while retailers in practice may almost universally pass the tax on to consumers, the law clearly imposes the tax on the retailer. It remains a retailer's business decision as to how to compensate for that tax expense.

Real & Personal Property Law> Estates, Rights & Titles> Licenses
Real & Personal Property Law> Landlord & Tenant> Commercial Leases
Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
[HN9] Under *NM Stat. Ann. § 7-9-53(A}* (1998), receipts from the sale or lease of real property may be deducted from gross receipts. Leasing is defined as an arrangement whereby, for a consideration, property is employed for or by any person other than the owner of the property. *NM Stat. Ann. § 7-9-3(J)* (2002). The granting of a license to use property is the sale of a license and not a lease. Under N.M. Admin. Code tit. 3, ch. 2, pt. 211, § 17(A) (2002), receipts derived from a license to use real property may not be deducted from gross receipts. '"

Real & Personal Property Law> Estates, Rights & Titles> Licenses
Real & Personal Property Law> Landlord & Tenant> Commercial Leases
[HNIO] The difference between a license and a lease is that a lease gives to the tenant the right of possession against the world, while a license creates no interest in the land, but it is simply the authority or power to use it in some specific way. For a lease to exist, the lessee must acquire some definite control of and dominion over the premises. A lease conveys exclusive possession of the premises to the tenant, arid thus, the tenant holds an estate. In contrast, a licensor retains legal possession of the land, and the licensee has only a privilege to enter for a particular purpose.

Real & Personal Property Law> Estates, Rights & Titles> Licenses
[HN 11] In determining whether agreements are licenses or leases, a license is defined as permission by competent

authority to do an act which, without such permission, would be illegal, a trespass, a tort, or otherwise not allowable.

Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
Tax Law> State & Local Tax > Administration & Proceedings
[HN12] A taxpayer is subject to a penalty for failure to pay gross receipts taxes due to negligence or disregard of rules and regulations, but without intent to evade or defeat a tax. *N.M. Stat. Ann. § 7-J-69(A)* (2001). Negligence is defined as the failure to exercise that degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances, and as carelessness, erroneous belief or inattention. N.M. Admin. Code tit. 3, ch. I, pt. II, § 10(A), (C) (2002).

Tax Law> State & Local Tax > Income Tax > Individuals, Estates & Trusts
Tax Law> State & Local Tax > Administration & Proceedings
[HNI3] Penalties may properly be assessed even when the failure to pay is based on inadvertent error or unintentional failure to pay the tax due.

COUNSEL:
Matthew E. Cohen, Albuquerque, NM, Clara Ann Bowler, Albuquerque, NM, for Appellant.

Patricia A. Madrid, Attorney General, Bl11ce J. Fort, Special Assistant Attorney General, Santa Fe, NM, for Appellee.

JUDGES:
JONATHAN B. SUTIN, Judge. WE CONCUR: A. JOSEPH ALARID, Judge, CYNTHIA A. FRY, Judge.

OPINION BY:
JONATHAN B. SU11N

OPINION:

SUTIN, Judge.

[*1] Taxpayer Vicki C. Grogan, d/b/a Tobacco Patch, appeals from a New Mexico Taxation and Revenue Department hearing officer's decision and order upholding the Department's gross receipts tax assessment against Taxpayer's unreported receipts from "buy-down" contracts and "shelf-display" contracts with cigarette manufacturers. Taxpayer also appeals the Department's assessment of a penalty for negligence. We affirm.

BACKGROUND

[*2] Taxpayer is a sole proprietor engaged in the retail sale of tobacco products purchased from wholesale suppliers. She entered into two types of written contracts directly with cigarette manufacturers. These contracts are known in the industry as "buy-down" [**2] and "shelf- display" contracts.

The Buy-down Contracts

[*3] Under the buy-down contracts, Taxpayer agreed with the manufacturers to advertise and sell cigarettes at a specified discount for a specified period of time, known as the promotion time. The manufacturers paid Taxpayer amounts (hereafter payments) that essentially made up the difference between Taxpayer's usual retail price and the discounted price set in the contracts.

[*4] It is the manner in which the parties characterize the nature of the payments that creates the issue for appeal. Taxpayer contends the payments are inventory based. She asserts that, under the contracts, the payments are refunds based on Taxpayer's inventory, not based on sales. Taxpayer thus characterizes the contracts as involving the cost of doing business. She argues that the discount benefits the manufacturers because it reduces Taxpayer's inventory expenses, allowing her to offer special discounts and thereby increase her volume of sales. She points out that the evidence, consisting of worksheets she prepared for the manufacturers, showed that the payments were based on inventory records from which Taxpayer set out her beginning [**3] inventory, inventory thereafter purchased, and ending inventory. From this, Taxpayer argues that the manufacturers intended to give a discount based on inventory, because "if the manufacturers intended to give a discount on sales, [they] would have calculated the discount directly from Taxpayer's retail sales records."

[*5] The Department describes the contracts as ones in which Taxpayer is either (1) being reimbursed by the manufacturers for the revenue foregone from selling cigarettes at a discounted price, or (2) receiving consideration for promoting the sale of cigarettes at a discounted price. The Department argues that the arrangement does not create a "retroactive discount" on new purchases of inventory. The nature of the buy-down programs, the Department explains, is not that of inventory purchase and reduction, lowering the cost of doing business by the payments. Rather, the Department asserts, the nature of the programs is that of keeping track of cigarettes sold at a discount and then receiving payments for the promoted sales.

[*6] The hearing officer entered the following findings of fact:

5. Under the terms of her buydown contracts (also referred [**4] to by some manufacturers as a "price promotion" or "discount program"), the Taxpayer agreed to reduce the price of certain brands of cigarettes by a specified dollar amount for a specified period of time. The Taxpayer also agreed to cooperate with the cigarette manufacturer in posting signs to advertise the discounted price. In return, the manufacturer agreed to pay the Taxpayer the difference between her usual retail price and the discounted price of the cigarettes covered by the agreement.

6. The amount of the buydown was determined by calculating the Taxpayer's inventory of covered cigarettes on the day the promotion began, adding inventory purchased during the promotion and then. subtracting the inventory remaining at the end of the promotion. The resulting figure, which equaled the number of cigarettes sold at the discounted price, was then multiplied by the amount of the discount.

7. Because the Taxpayer was reimbursed the exact amount of the sales discount, the buydown program did not generate additional profit for the Taxpayer on a per pack or per carton basis. The Taxpayer did benefit, however, from the increased traffic and sales volume that resulted from [**5] selling cigarettes at a discounted price.

8. When selling cigarettes under the terms of a buydown contract during the audit period, the Taxpayer charged her customers gross receipts tax on the discounted price and did not include the buydown amount she received from the manufacturer when reporting her gross receipts to the Department.

Taxpayer challenges findings of fact numbered 5 and 7. She also challenges the hearing officer's conclusion of law number 2 that "the Taxpayer's receipts from her buy- down contracts with cigarette manufacturers come within the definition of gross receipts and are subject to tax."

The Shelf-Display Contracts

[*7] Under one-year shelf-display contracts, representatives of the manufacturers set up and stocked their own shelf and counter displays at a designated location in Taxpayer's store. The dispute centers on whether these contracts constituted leases or licenses.

[*8] The hearing officer found that, under the terms of these contracts, Taxpayer (1) permitted manufacturers "to place free-standing, movable shelves at designated places in the store and temporary displays on the counter or hanging from the [..6] ceiling"; (2) gave manufacturers a priority over shelf and advertising placement and feet of shelf space based on sales volume; and (3) agreed that each manufacturer would set up and stock its own displays, but had access to do so only during the hours Taxpayer's store was open. 6 a.m. to 6 p.m., six days a week. The hearing officer also found that Taxpayer kept the shelves stocked for the manufacturers during the month-long period between the representatives' visits to the store. The hearing officer concluded that "the Taxpayer's receipts from her shelf- display contracts with cigarette manufacturers are not receipts from the lease of real property, and the Taxpayer is not entitled to the deduction provided in [the statutes]." Taxpayer challenges this conclusion of law. Taxpayer does not challenge the findings of fact, but contends evidence presented at trial not recited in the findings should be considered.

The Assessment, Protest, and Administrative Decision

[*9] In an administrative hearing on Taxpayer's protest, the Department's hearing officer upheld the Department's assessments of (1) gross receipts tax of $23,931.86 on unreported "buy-downs" received [**7] by Taxpayer from manufacturers; (2) tax of $555.23 on unreported receipts under the shelf-display contracts; (3) a penalty based on Taxpayer's negligence; and (4) interest associated with the two assessments. Pursuant to *NMSA* 1978, § 7-1-25 (1989), Taxpayer appeals the hearing officer's decision and order upholding the Department's assessments of gross receipts tax and penalty.

DISCUSSION

A. The Standard of Review and Presumptions

[*10] [lIN1] We will set aside the "decision and order of the hearing officer only if found to be: (I) arbitrary, capricious or an abuse of discretion; (2) not supported by substantial evidence in the record; or (3) otherwise not in accordance with the law." § 7-1-25(C); *Car/sberi Mgmt. Co. v. Taxation & Revenue Dep't.* 116 *NM* 247, 249, 861 *P.2d* 288, *290 (Ct. App.* 1993). "We view the evidence in the light most favorable to the [Department's] decision to determine whether the decision is supported by: substantial evidence in the record as a whole." Id; *Brim Hea/thcare, Inc. v.' Taxation & Revenue Dep't, 119NM.* 818, 819, *896P.2d* 498, 499 *(Ct. App.* 1995). To the [**.8] extent our review involves interpretation of a statute, or the application of law to undisputed facts, the review is de novo. *Quantum Corp. v. Taxation & Revenue Dep't,* 1998 *NMCA 50, P8.. 125N.M* 49, 956 *P.2d* 848.

[*11] [HN2] There exists a statutory presumption that all receipts are taxable. *NMSA* 1978, § 7:09-5 (1966) (amended 2002). The taxpayer claiming that receipts are not taxable bears the burden of proving that assertion. *TPL, Inc. v. Taxation & Revenue Dep't, 2000 NMCA* 83, *P8,* 129 *N.M* 539, *10 P.3d* 863, cert. granted, 129 *N.M* 519, *10 P.3d* 843; *I1TEduc. Servs., Inc. v. Taxation & Revenue Dep't,* 1998 *NMCA* 78, *P5,* 125 *N.M.* 244, 959 *P.2d* 969; *Brim Healthcare,* 119 *N.M* 818 *at 820,* 896 *P.2d at 500; Wing Pawn Shop v. Taxation & Revenue Dep't,* 111 *N.M.* 735, 741, *809 P;2d* 649, 655 *(Ct. App.* 1991).

[*12] [HN3] The Department's assessment is presumed to be correct. *NMSA* 1978, § 7-1-17(C) (1992); *Carlsberg,* 116 *NM.* 247 *at* 249, 861 *P.2d at 290.* "The effect of the presumption [**9] of correctness is that the taxpayer has the burden of coming forward with some countervailing evidence tending to dispute the factual correctness of the assessment made by the secretary. Unsubstantiated statements that the assessment is incorrect cannot overcome the presumption of correctness." 3.1.6.12(A) NMAC 2001.

B. The Buy-down Contract Payments Are Taxable

[*13] Our initial inquiry is whether the payments made under the buy-down contracts constitute taxable gross receipts. The inquiry centers on whether the payments are to be taxed as reimbursements of revenue that would have otherwise been lost due to the sale of cigarettes at a discounted price, or whether the payments are to be viewed as a method of lowering the cost of doing business and therefore are not taxable. The inquiry includes whether the payments fall within the statutory exclusion for "cash discounts allowed and taken" contained in *NMSA* 1978, § *7-9-3(F)(2)(a)* (2002).

[*14] Taxpayer suggests that if we look at the substance of the transactions, and not simply at generalized rules and regulations, the result will favor Taxpayer. The Department simplifies the [**10]' transaction in these words: The payments merely "put[] the same amount of money in [Taxpayer's] bank accounts as she would have [had] had the cigarettes sold for the original retail price."

1. Reimbursement vs. Reduction of Inventory Costs

[*15] [HN4] "'Gross receipts' means the total amount of money or the value of other consideration received from selling property in New Mexico, ...or from performing services in New Mexico." § 7-9-3(F). We are persuaded that the payments constitute gross receipts under Section 7-9-3(F). We do not accept Taxpayer's underlying premise that the manufacturers discounted her inventory purchases through payments "directed to Taxpayer's cost of doing business." Therefore, we do not accept her contention that gross receipts tax cannot be assessed against her as a purchaser of product, but rather only against her suppliers as sellers. The payments are reimbursements to Taxpayer for her sales loss incurred as a result of engaging in the discount promotions. The payments place her in the same position as if she had sold the cigarettes at the non-discounted price.

[*16] The hearing officer stated in her decision that [**11] under several of Taxpayer's buy-down contracts. Taxpayer agreed to perform promotional services in order to receive the payments. Based on this finding, the hearing officer concluded that the gross receipts tax constituted either "additional consideration for the sale of cigarettes" or "consideration for performing promotional services," under Section 7-9-3(F). See § 7-9-3(F) (defining gross receipts to include "the value of other consideration received from selling property"). Because we determine that the payments constitute "money... from selling property" under Section 7-9-3(F), we need not address whether the conclusion reached by the hearing officer provides an alternative, independent basis for upholding the gross receipts tax assessment. We state only that the valuable and mutual benefit to the manufacturers and to Taxpayer intended from the buy-down contracts, at the very least, supplies strong support for the conclusion that these types of payments were intended by the Legislature to constitute gross receipts under Section 7-9-3(F).

2. Cash Discounts Allowed and Taken

[* 17] [HN5] "'Gross receipts' excludes: (a) cash discounts allowed and taken. [**12] "§ 7-9-3(F)(2)(a). This exclusion provides a tax exemption. When a taxpayer relies on an exemption, we construe the statute strictly in favor of the Department. *TPL, Inc., 2000 NMCA* 83, *P8* (stating that "when a taxpayer claims a tax deduction, the statute giving rise to such a deduction 'must be construed strictly in favor of the taxing authority"') (quoting *Sec. Escrow Corp.* v. *Taxation & RevenueDep't.107N.M. 540,* 543, *760 P.2d 1306, 1309 (Ct. App.* 1988)). As we stated in TPL, Inc.: "Put another way, taxation is the rule and the burden is on the taxpayer to bring itself within any claimed exception." Id.

[*18] Furthermore, the taxpayer must clearly establish the exemption. *Wing Pawn Shop, J J J N.M.* 735 *at 740, 809 P.2d at* 654. In addition, "the right to the exemption ...must be clearly and unambiguously expressed in the statute." Id.

[*19] [HN6] The Department's regulation based on the Section 7-9-3(F)(2) exclusion reads:

Discount coupons: The gross receipts attributable to a sale in which a seller accepts discount coupons provided by buyers are measured by the cash received plus the value of the coupon. However, [**13] if the discount coupon is not redeemable by the seller, the acceptance of the coupon constitutes a cash discount allowed and taken and is excluded from gross receipts.

3.2.1.14(1) NMAC 2002. This regulation is presumed to be a proper implementation of the statute. *NMSA* 1978, § 9-1 *1-6.2(G)* (1995) (comparable provisions formerly *NMSA* 1978, § *7-1-5(G)* (repealed 1995»; *Hawthorne v. Taxation & Revenue Dep't,* 94 *N.M 480.* 481. 612 *P.2d 710.* 711 *(Ct. App. 1980)* ("Any regulation ...issued by . the [commissioner] is presumed to be in proper implementation of the provisions of the revenue laws administered by the [bureau]." (alteration in original». The regulation is entitled to substantial weight. See *State ex rel.. Battershell v. City of Albuquerque, 108 N.M* 658. 662, 777 *P.2d* 386, *390 (Ct. App.* 1989); *Strebeck Props.. Inc. v. Bureau of Revenue,* 93 *N.M* 262, 268, 599 *P.2d 1059, 1065 (Ct. App.* 1979) (recognizing that "administrative interpretations are entitled to great weight in ascertaining the meaning of the statute"); *Miller v. Bureau of Revenue.* 93 *N.M* 252, 254, 599 *P.2d 1049, 1051 (Ct. App.* 1979) [**14] ("The construction given a statute by the administrative agency charged with the enforcement of it is a significant factor to be considered by the courts in ascertaining the meaning of such statute.") (internal quotation marks and citation omitted).

[.20] The Department explains its regulation as follows:

Where a merchant is able to redeem the coupon from the manufacturer, the amount of that redemption is a taxable receipt. Where the merchant cannot redeem the coupon, the coupon represents a cash discount allowed and taken. The two types of coupons discussed in the regulation are sometimes referred to as "manufacturer's coupons" and "store coupons," respectively. "Store coupons" are not taxable since the merchant receives nothing; "manufacturer's coupons" are taxable to the face value of the coupons.

The Department argues that the payments at issue in this case are, in substance, redemptions by a merchant of a manufacturer's coupon, in that, according to the Department, the retailer receives consideration from the manufacturer to reimburse the merchant for revenues which would otherwise have been lost on the sale at a discounted price.

[*21] Taxpayer [**15] contends that we should disregard the distinction advanced by the Department between a manufacturer's coupon and a retailer or store coupon because such a distinction is not found in Section 7-9-3(F)(2)(a). Taxpayer interprets the statute to exclude cash discounts allowed and taken at the time of sale, regardless of whether the discounts emanate from the retailer or manufacturer. Taxpayer also argues that the "payments were not generated by her acceptance of a discount coupon from her consumers and, therefore, NMAC 3.2.1.14 I does not apply." Further, Taxpayer asserts that the exclusion is designed to encourage taxpayers to engage in discount sales, and the interpretation of the statute advanced by the Department violates that legislative purpose because it will discourage, rather than encourage, discount sales. Taxpayer does not support these contentions with authority, evidence, or persuasive rationale.

[*22] A more reasonable explanation of the exclusion's purpose is that it assures retailers, who discount the original retail price and receive no manufacturer reimbursement for the discounted amount, that they will not be taxed under the very broad definition of gross [**16] receipts in Section 7-9-3(F). Also, the words "cash discounts allowed and taken" more reasonably fit the circumstance in which a retailer chooses, for whatever reason, to accept less for the product sold, no matter what the value of the product. [HN7] A retailer who is reimbursed the discounted amount does not absorb the cash loss. Such a retailer is in no position to claim an exclusion. Taxpayer has failed to clearly establish her right to claim such an exclusion. See *Wing Pawn Shop,* 111 *N.M* 735 *at* 741, *809 P.2d at* 655; *Proficient Food Co.* v. *Taxation & Revenue Dep't, 107 N.M* 392, 397, 758 *P.2d 806,* 811 *(Ct. App.* 1988) (holding retailer failed to cite authority to support its argument and failed to establish its right to claim the deduction allowed for sales to a buyer who resells).

[*23] We agree with the Department's view of the exclusion. The Department's regulation and its explanation of how the regulation works are sensible interpretations of the Section 7-9-3(F)(2)(a) exclusion. The circumstances here are little different than if the-manufacturers issued coupons to consumers who presented the coupons to Taxpayer to receive cigarettes at [**17] a discounted price, and Taxpayer then presented the coupons to the manufacturers to obtain reimbursement for the discounted amount.

[*24] Taxpayer expresses concern that treating the buy-down contracts as taxable manufacturer coupons places her in the circumstance of not being able to pass the tax on to either the consumer or the manufacturer. Returning to her underlying rationale, Taxpayer asserts her "inability to pass along the tax ...arises because the discount payments are linked to [her] inventory purchases ...rather than to paper coupons brought in by the consumer as part of the sale," thus purportedly showing the lack of connection between the payments and her retail sales. Taxpayer's expressed concern does not persuade us. She took no steps to ascertain in advance from the Department, from legal counselor a tax expert, or even from local business associations, whether the payments might be taxable and what the risks might be in failing to report such receipts. [HN8] "Every person is charged with the reasonable duty to ascertain the possible tax consequences of his action." . *Tiffany Constr. Co. v. Bureau of Revenue, 90 N.M* 16, 17, 558 *P.2d* 1155, 1156 *(Ct. App.* 1976) [..18] (affirming penalty assessment based on negligence); see also *Arco Materials, Inc. v. Taxation & Revenue Dep't,* 118 *N.M* 12, 15, 878 *P.2d 330,* 333 *(Ct. App.* 1994) ("A taxpayer has an affirmative duty to keep informed about changes in the tax law that might affect its liability."), rev'd on other grounds sub nom. *Blaze Constr. Co. v. Taxation & Revenue Dep't,* 118 *N.M* 647, 884 *P.2d 803* (1994). Furthermore, while retailers in practice may almost universally pass the tax on to consumers, the law clearly imposes the tax on the retailer. It remains a retailer's business decision as to how to compensate for that tax expense.

[*25] We hold that the hearing officer's decision and order in regard to the buy-down payments was not arbitrary or capricious, and was not an abuse of discretion or contrary to law, and that her findings were supported by substantial evidence.

C. The Shelf-Display Contract Receipts Are Taxable

[*26] [HN9] Under *NMSA* 1978. § *7-9-53{A}* (1998), "receipts from the sale or lease of real property ...may be deducted from gross receipts." Leasing is defined as "an arrangement whereby, [**19] for a consideration, property is employed for or by any person other than the owner of the property." § 7-9-3 (J). "The granting of a license to use property is the sale of a license and not a lease." Id. Under 3.2.211.17(A) NMAC 2002, "receipts derived from a license to use real property may not be deducted from gross receipts." Taxpayer contends the shelf-display contracts are leases; the Department contends the contracts are licenses.

[*27] The facts in the present case do not show sufficient dominion over and control of property by the cigarette manufacturers to constitute a leasehold interest. The manufacturers have neither exclusive possession nor the right to restrict access to the designated areas in Taxpayer's store. The contracts do not create or convey an interest in real property; they simply give the manufacturers authority to set up or use shelves and counters in the store for product and advertising displays. [HNIO] "The difference between a license and a lease is that a lease gives to the tenant the right of possession against the world, while a license creates no interest in the land, but it is simply the authority or power to use it in some specific way." *Cutter Flying Serv., Inc.* v. *Prop. Tax Dep't,* 91 *N.M* 215, 219, 572 *P.2d* 943, 947 *(Ct. App.* 1977) [**20] (internal quotation marks and citation omitted). For a lease to exist, the lessee must acquire some definite control of and dominion over the premises. *Id. at 219-20,* 572 *P.2d at* 947-48. "[A] lease conveys exclusive possession of the premises to the tenant, and thus, the tenant holds an estate. In contrast, a licensor retains legal possession of the land, and the licensee has only a privilege to enter for a particular purpose." Jon W. Bruce & James W. Ely, Jr., The Law of Easements and Licenses in Land, P 11.01 (Rev. ed. 1995) (footnote omitted).

[*28] Taxpayer argues that the manufacturers' installations of displays constitute fixtures, which evidence dominion over and control of real property and indicate the parties' intent that the contracts are leases. She further argues that her maintenance duties merely confirm the manufacturers' dominion and control, in that the duties are limited to the manufacturers' specific instructions, relegating Taxpayer to the status of agent of the manufacturers.

[*29] Taxpayer cites *Quantum,* 1998 *NMCA 50, PP2-3.* in support of her arguments. In Quantum, the taxpayer remodeled and customized buildings [**21] for bingo game use under the Bingo and Raffle Act, *NMSA* 1978, § § *60-2B-1* to -14 (1981, as amended through 1999), and entered into agreements permitted under the Bingo Act with non-profit organizations that conducted bingo games in the buildings during specified sessions. *Quantum.* 1998 *NMCA 50. P2.* [HNll] In determining whether the agreements were licenses or leases, we defined "license" as "'permission by competent authority to do an act which, without such permission, would be illegal, a trespass, a tort, or otherwise not allowable.' Black's Law Dictionary 920 (6th ed. 1990)." 1998 *NMCA 50 P 10.* Our analysis of the parties' intent, which in turn required and caused a rather extensive court analysis of the entire content of the agreements, led us to conclude that the agreements were leases within the meaning of

Section *7-9-53(A).* 1998 *NMCA 50 PP12-22.* Without repeating that lengthy discussion, we see little resemblance between Taxpayer's shelf-display contracts and the use of the taxpayer's buildings for bingo games in Quantum. In the present case, as indicated above, the "real estate" being used is shelves and counters. The manufacturers' representatives visit [..22] the store monthly, and can do so only during the hours the store is open for business. That Taxpayer was required to maintain the shelves indicates as much an equal and independent access and right to use the property as it does a right maintained solely as an agent in furtherance of the manufacturers' exercise of dominion and control. While in Quantum the taxpayer reserved some degree of control over the premises through provisions "such as those regarding public liability insurance, security guards, parking, thermostat settings, bankruptcy, and right of entry," we discounted these circumstances as "not uncommon to modem commercial leasing," and as necessary for compliance with statutory regulation. 1998 *NMCA 50 P20.*

[*30] It was also important in Quantum that the regulatory statute, the Bingo Act, "contemplated ...a lease [as] a vehicle for non-profit organizations to use premises for conducting bingo games." 1998 *NMCA 50 P21.* This and several other aspects of the circumstances set out in Quantum sufficiently distinguish that case from the present to make Quantum inapplicable as instructive, much less controlling, precedent.

[*31] In sum, the shelf-display [**23] contracts bear a much greater resemblance to a license than to the creation and conveyance of an interest in real property that would constitute a lease. The hearing officer's determination that the shelf-display contracts were not leases as contemplated under Section 7-9-53(A) was not arbitrary, capricious, or an abuse of discretion, was supported by substantial evidence, and was in accordance with law.

D. The Penalty Assessment Was Proper

[*32] [HN12] A taxpayer is subject to a penalty for failure to pay gross receipts taxes "due to negligence or disregard of rules and regulations, but without intent to evade or defeat a tax." *NMSA* 1978, § *7-1-69(A)* (2001). Negligence is defined by our administrative code both as the "failure to exercise that degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances," and as "carelessness, erroneous belief or inattention." 3.1.11.10(A), (C) NMAC 2002; see *Sonic Indus., Inc. v. State, 2000 NMCA* 87, *P38.* 129 *N.M.* 657, 11 *P.3d* 1219. The hearing officer determined that Taxpayer's failure to pay gross receipts tax was negligent, [**24] based on her finding that the failure was due to Taxpayer's "lack of knowledge and her erroneous belief that tax was not due on certain transactions."

[*33] Taxpayer asserts that she is not subject to penalty because her business is "a very small business" and because she consulted with manufacturers about local business practice before making her decision regarding tax liability. Taxpayer testified that the manufacturers "told me the [tax] laws to go by and to look at."

[*34] While Taxpayer indicates that the penalty is inappropriate because she operates a small business and made some effort to inquire about her tax liability by discussing the tax issue with the manufacturers, Taxpayer hinges her position on the hearing officer's comments that Taxpayer's failure to pay tax on the buy-down and shelf-display contract receipts was an "honest mistake," and on the Department's attorney's statement that liability was a "close issue."

[+35] We see no basis on which to conclude that the hearing officer acted arbitrarily or capriciously, or abused her discretion in concluding Taxpayer was negligent under Section 7-1-69(A). Nor can we say the conclusion was not in [**25] accordance with law. Further, despite the verbal comments at the hearing, the hearing officer's determination of negligence was supported by substantial evidence. Taxpayer did not demonstrate that she reasonably attempted to ascertain .whether her actions were justifiable under the tax statutes and regulations. Cigarette manufacturers are not tax experts upon whom Taxpayer could justifiably rely. See *Sonic Indus., 2000 NMCA* 87, *P39* (requiring the taxpayer "to demonstrate that it had acted reasonably" by "coming forward with evidence showing that it had consulted with tax professionals and [had] developed compelling arguments for overruling our prior cases".); *Arco Materials,* 118 *NM.* 12 *at* 16, 878 *P.2d at* 334 ("New Mexico case law is clear that [HN13] penalties may properly be assessed even when the failure to pay is based on inadvertent error or unintentional failure to pay the tax due.").

CONCLUSION

[*36] The hearing officer's decision and order is affirmed.

[*37] **IT IS SO ORDERED**.

JONATHAN B. SUTIN, Judge

WE CONCUR:

A. JOSEPH ALARID, Judge

CYNTHIA A. FRY, Judge

1 of2 DOCUMENTS

VICKI C. GROGAN, d/b/a TOBACCO PATCH, I.D. NO. 02-397117-00 7, Petitioner-Petitioner, v. NEW MEXICO TAXATION AND REVENUE DEPARTMENT, Respondent-Respondent.

NO. 27,856

SUPREME COURT OF NEW MEXICO

***1003 N.M. LEXIS* 34**

January 31,2003, Decided

NOTICE:
[*1] DECISION WITHOUT PUBLISHED OPINION

PRIOR HISTORY:
Grogan v. N.M *Taxation & Revenue Dep't, 2002* NM *App. LEXlS* 125 (N.M. Ct. App. Dec. 11,2002).

OPINION:

ORDER

This matter coming on for consideration by the court upon petition for writ of certiorari, and the Court having considered said petition, and being sufficiently advised, Chief Justice Petra Jimenez Maes, Justice Pamela B. Minzner, Justice Patricio M. Serna, and Justice Richard C. Bosson concurring;

NOW, THEREFORE, IT IS ORDERED that the petition for writ of certiorari is denied in Court of Appeal number 22552.

IT IS SO ORDERED.